CHAPTER

3

Revenue Options

Revenue Option 1

Raise Marginal Tax Rates for Individuals

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues							
Raise All Tax Rates on Ordinary Income by 1 Percentage Point	+3.9	+5.6	+5.4	+5.7	+5.8	+26.4	+78.6
Raise All Ordinary Tax Rates and AMT Rates by 1 Percentage Point	+6.4	+9.4	+9.8	+10.6	+11.4	+47.6	+113.3
Raise All Ordinary Tax Rates, AMT Rates, and Dividend and Capital Gains Rates by 1 Percentage Point	+6.6	+10.7	+11.2	+11.9	+11.6	+52.0	+118.8
Raise the Top Two Ordinary Tax Rates by 1 Percentage Point	+2.4	+3.5	+3.5	+3.8	+4.1	+17.3	+50.2

Source: Joint Committee on Taxation.

Under current law, individuals face six statutory tax rates on taxable income earned between tax years 2004 and 2010: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent. After 2010, the schedule of rates reverts to the five brackets (15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent) that were in effect before the Economic Growth and Tax Relief Reconciliation Act of 2001 was enacted. This option would provide several alternatives for raising statutory tax rates under the individual income tax:

- Raise all tax rates on ordinary income by 1 percentage point.
- Raise all ordinary tax rates and the rates of the alternative minimum tax (AMT) by 1 percentage point.
- Raise all ordinary tax rates and the AMT rates by 1 percentage point, and raise the separate rates on dividends and capital gains by 1 percentage point.
- Raise the top two ordinary tax rates by 1 percentage point.

The increase in revenues under this option would depend on whether the rate hike applied to all rates or only to rates on dividends and capital gains or those for the AMT.

An individual's taxable income may be taxed at different rates (see the table on the next page). For example, in 2005, a single person with taxable income of $30,000 would pay a rate of tax of 10 percent on the first $7,300 of income, 15 percent on the next $22,400, and 28 percent on the last $300. The starting points for the brackets would be indexed for inflation beyond 2005.

Starting Point for Each Rate Bracket (2005 dollars)		Statutory Tax Rates on Ordinary Taxable Income (Percent)	
Single Filers	Married Filers	2005-2010	After 2010
0	0	10	15
7,300	14,600	15	15
29,700	59,400	25	28
71,950	119,950	28	31
150,150	182,800	33	36
326,450	326,450	35	39.6

But not all income that goes to individuals is taxed at those rates. Income from long-term capital gains (gains on assets that are held for more than one year) is subject to lower rates under a separate schedule; the same applies to dividend income through 2008. And taxpayers subject to the AMT face statutory tax rates of 26 percent and 28 percent.

Boosting all statutory tax rates on ordinary income by 1 percentage point would increase revenues by about $26.4 billion from 2006 to 2010. Under that option, for example, the top rate of 35 percent in 2010 would rise to 36 percent, and the top rate of 39.6 percent during the 2011-2014 period would increase to 40.6 percent. The AMT's rates (26 percent and 28 percent) would remain the same as under current law.

Another alternative would be to *raise each of the regular tax rates and also the AMT's rates by 1 percentage point*, which could increase revenues during the 2006-2010 period by $47.6 billion. The change from year to year in the estimate of additional revenues under this approach is less affected by the number of taxpayers subject to the AMT than is the change under the previous alternative. That is because taxpayers who face the alternative tax are also subject to the increase in statutory tax rates. If *in addition to raising the AMT's rates, policymakers pushed up the separate tax rates on capital gains and dividends by 1 percentage point*, the government would collect $52.0 billion in additional revenues from 2006 to 2010.

Raising only some of the statutory tax rates would be another alternative. For example, *boosting only the top two marginal rates* would raise $17.3 billion over the 2006-2010 period. Since most of the taxpayers facing the top two rates on the ordinary rate schedule are not subject to the alternative minimum tax, the AMT would not limit the impact of the rise in regular tax rates.

These estimates incorporate the assumption that taxpayers will respond to the higher tax rates by changing their behavior—chiefly, by shifting income from taxable to nontaxable or tax-deferred forms. (Such a shift might involve substituting tax-exempt bonds for other investments or exchanging tax-free fringe benefits for compensation in cash.) But the estimates do not incorporate potential alterations in how much people work or save in response to the change in statutory tax rates. How the various alternatives might affect the overall economy is uncertain; estimates of their impact would depend on the methods and assumptions used in such an analysis.

Increases in tax rates have some administrative advantages over other types of tax hikes because they require relatively minor changes in the current system of tax collection. But rate increases have drawbacks as well. Higher tax rates reduce incentives to work and save. They also encourage taxpayers to shift income from taxable to nontaxable forms and to increase spending on items that are tax-deductible, such as home mortgage interest and charitable contributions. In those ways, higher tax rates cause economic resources to be allocated less efficiently than they might be.

RELATED OPTIONS: Revenue Options 4, 7, and 8

RELATED CBO PUBLICATIONS: *Effective Federal Tax Rates Under Current Law, 2001 to 2014*, August 2004; *Macroeconomic Analysis of a 10 Percent Cut in Income Tax Rates*, Technical Paper 2004-07, May 2004; *The Alternative Minimum Tax*, Revenue and Tax Policy Brief, April 2004; and *How CBO Analyzed the Macroeconomic Effects of the President's Budget*, July 2003

Revenue Option 2

Permanently Extend EGTRRA's Provisions for Tax Brackets and Married Filers

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues[a]	0	0	0	0	0	0	-604.1

Source: Joint Committee on Taxation.

a. Includes outlay effects.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) changed the individual income tax system in a number of ways, including reducing tax rates across the board and providing relief from the marriage penalty. EGTRRA created a new 10 percent tax bracket; in addition, the 28 percent rate was reduced to 25 percent, the 31 percent rate to 28 percent, the 36 percent rate to 33, and the 39.6 percent rate to 35 percent. The law also reduced taxes for married couples who file a joint return by increasing the standard deduction, the size of the 15 percent tax bracket (the amount of income subject to that tax rate), and the phaseout range of the earned income tax credit.

EGTRRA's provisions for tax rates and marriage penalty relief are scheduled to expire in 2010; this option would permanently extend them. (The President's budget for 2006 includes similar proposals.) The option would not lower revenues over the 2006-2010 period but would reduce them from 2011 through 2015 by $604.1 billion.

Permanently lowering tax rates would increase economic efficiency by lessening distortions that arise from the tax system. High tax rates distort people's economic decisions: they encourage taxpayers to shift income from taxable to nontaxable forms (such as substituting tax-exempt bonds for other investments or tax-free fringe benefits for cash compensation) and to increase spending on tax-deductible items, such as home mortgage interest and charitable contributions.

Lower tax rates could also encourage people to work and save. However, the rates' ultimate effect on economic output would depend on whether countervailing changes were made elsewhere in the budget. Financing the tax cuts through increased deficits would reduce national saving and might offset the positive effects of lower tax rates on the number of hours worked in the economy and on private saving.

Equity, or fairness, is another criterion in assessing tax policy. Evaluations of the fairness of raising statutory income tax rates may differ, depending on the metric used to measure fairness. Because a large share of the increased revenues from the rate hikes would come from taxpayers with the highest income, some observers might argue that the rate increases were progressive. But the across-the-board nature of the rate increases leads to a similar percentage rise in the taxes paid by all other income groups. That outcome implies that each income group will continue to pay about the same share of the total income tax burden as it does under current law, a result that some observers would contend was proportional.

Fairness would also be an issue regarding extending the provisions in EGTRRA that offer relief from the marriage penalty. Many married couples who file a joint return have larger tax liabilities than they would have if they were allowed to file as individuals or as heads of households (single taxpayers with dependents). At the same time, many other married couples pay lower taxes than they would pay if they filed as single taxpayers. Whether a couple incurs a marriage penalty or receives a marriage bonus depends on the relative income of the two spouses: penalties generally occur when spouses have similar income, and bonuses occur when only one spouse works or when spouses have substantially different earnings. On the one hand, permanently extending EGTRRA's marriage relief provisions would reduce marriage penalties and increase equity by treating some married couples on a par with their single counterparts. On the other hand, extending those provisions would not only reduce marriage penalties but also increase marriage bonuses. The latter outcome would effectively penalize unmarried taxpayers relative to their married counterparts.

Many analysts have observed that the marriage penalty affects couples' decisions about whether to marry and how much to work. Reducing the extent of the penalty would weaken any deterrent effect on marriage and, if the changes in EGTRRA were made permanent, simplify families' financial planning. In addition, because this option would lower the marginal tax rate (the rate that applies to a taxpayer's last dollar of income) for many couples, it might help reduce the adverse impact of taxes on incentives to work. Research has shown that how much a secondary earner works—in a two-earner couple, the spouse with the lower income—is particularly sensitive to tax rates.

RELATED OPTION: Revenue Option 7

Revenue Option 3

Permanently Extend the 5 Percent and 15 Percent Tax Rates for Capital Gains and Dividends

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	0	0	-2.6	-12.5	-7.0	-22.1	-159.7

Source: Joint Committee on Taxation.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced the special tax rates that apply to most capital gains. For gains that had been taxed at 20 percent, the law lowered the rate to 15 percent; for gains that had been taxed at either 8 percent or 10 percent, JGTRRA reduced the rate to 5 percent. Which rate applies depends on the income of the individual who realizes the gain. The 15 percent rate on gains is used by people whose income puts them in the top four tax brackets for ordinary income (25 percent, 28 percent, 33 percent, or 35 percent). The 5 percent rate applies to people whose income puts them in the two lowest brackets (10 percent or 15 percent). In a major innovation, JGTRRA extended the 5 percent and 15 percent rates to dividends from domestic and qualifying foreign corporations, thus reducing the tax rates on such dividends from the rates on ordinary income to those on capital gains. Under the law, the rates are effective from 2003 through 2008. In 2008, the 5 percent tax rate is scheduled to drop to zero.

This option would permanently extend the 5 percent and 15 percent rates on gains and dividends. It would reduce revenues by $22.1 billion for the 2006-2010 period and $159.7 billion for 2006 through 2015. The reduction in revenues over the 10-year period is much more than double the drop during the first five years because the option would not change tax rates under current law until January 1, 2009. The President, in his 2006 budget, proposes to permanently extend the zero and 15 percent rates of 2008.

The lower tax rates on capital gains and dividends reduce the extra tax burden that under current law is carried by equity invested in C corporations—that is, corporations subject to the corporate income tax. C corporations may be either large or small businesses. Small businesses can avoid the corporate income tax by organizing as S corporations, partnerships, sole proprietorships, or limited liability companies. The return on the equity invested in C corporations is corporate profits. The extra burden on that equity arises because corporate profits are generally taxed twice: they are subject to the corporate income tax (typically 35 percent) and can then be taxed again when they are received by individuals. The profits that remain after the firm pays the corporate income tax are either distributed as dividends or retained and reinvested by the corporation. Because reinvested earnings presumably increase the corporation's value (by about the amount invested), they also raise the value of the firm's stock. When individuals sell that stock, they pay capital gains tax on the reinvested earnings. Thus, the return on equity invested in C corporations is generally taxed once as corporate profits and a second time as dividends or capital gains. By reducing tax rates on the latter types of income, JGTRRA lessens but does not eliminate the extra tax burden.

Those extra taxes on corporate profits distort investment. They lead to a shift of some investment from C corporations to other business forms and to owner-occupied housing. They also encourage C corporations to finance more of their investments by selling bonds rather than stock and by retaining earnings (rather than paying dividends). Those distortions interfere with the allocation of investment to the use with the highest economic return. Consequently, they reduce economic efficiency and leave most people less well off.

JGTRRA mitigated those distortions by reducing the extra tax burden—but only for a short interval. Because the lower rates expire at the end of 2008, investments made after that time will not benefit from them at all, and many investments made between 2003 and 2008 will benefit only partially because some of their returns will be earned after 2008. Hence, many of the gains in efficiency that could result from the effects of the lower rates on the allocation of investment will not be realized unless JGTRRA's provisions are perceived to be permanent.

Other options for reducing the extra tax burden on corporate equity have been widely discussed. One alternative would exempt from taxation at the individual level dividends and capital gains paid from profits that had been fully taxed at the corporate level (see Revenue Option 24). Another approach would apply the same treatment to interest earnings and tax the income of C corporations at the same rate as income earned by other businesses.

Compared with those options, the reduced rates that JGTRRA provides are less complete and less targeted but simpler. JGTRRA's lower rates remove less of the extra burden from the return on corporate equity than those alternatives would and also apply more broadly, because they are not limited to dividends and gains from fully taxed corporate profits. Corporations, like individuals, receive extra deductions and credits for certain investments; therefore, the return on those investments is less burdened under current law than is the return on fully taxed profits. Furthermore, people realize capital gains from investments in unincorporated businesses and individually owned property, and neither of those kinds of investment is subject to the corporate profits tax. Imprecisely targeting its lower rates, as JGTRRA does, reduces their effectiveness because it fails to lessen the burden on fully taxed corporate earnings relative to all other investment returns. Complete and targeted leveling of the tax burden, however, would be more complicated to administer, and policymakers in the United States have never tried it. Targeting could be improved with little additional complication, though, by limiting the lower capital gains tax rates to gains on shares of C corporations.

The extent to which the extra tax burden on dividends distorts decisions about investment is uncertain. Some analysts believe that the distortion is minimal; they believe that taxes on dividends mainly affect share prices. If that was the case, reducing the extra burden on dividends would increase stockholders' return on their investment but encourage little more equity investment by corporations. Other observers argue that the tax burden on dividends does reduce such investment. Most analysts agree, however, that the extra burden on retained earnings distorts investment choices.

RELATED OPTION: Revenue Option 24

Revenue Option 4

Return Tax Rates to Their Level in 2002 or Freeze Rates at Their Current Level

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues							
Return rates and brackets to their level in 2002	+22.4	+32.2	+31.7	+33.8	+35.5	+155.6	-151.5
Permanently extend current tax rates	0	0	0	0	0	0	-566.6

Source: Joint Committee on Taxation.

Before 2001, the federal individual income tax had five brackets, under which income was taxed at 15 percent, 28 percent, 31 percent, 36 percent, or 39.6 percent. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created a 10 percent bracket beginning in 2001; for 2001 to 2006, other provisions lowered the top four tax rates in three stages—to 25 percent, 28 percent, 33 percent, and 35 percent. (The 15 percent rate was not changed.) The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) accelerated the lowering of those rates, and the Working Family Tax Relief Act of 2004 changed the indexation of the 10 percent bracket. All brackets are indexed for inflation throughout the 2005-2010 period. As with other provisions of EGTRRA and JGTRRA, the tax rates revert to their pre-2001 level after the laws expire on December 31, 2010.

This option has two variants: it would either reinstate the tax rates established by EGTRRA at their level in 2002 or freeze the rates at their current level. Both variants would retain indexing of the rates as specified under current law.

For 2002, the individual income tax brackets included the new 10 percent rate and rates for the higher tiers (27 percent, 30 percent, 35 percent, and 38.6 percent) that were each 1 percentage point lower than the rates in effect before 2001. Returning rates to their 2002 level would increase revenues by $22.4 billion in 2006 and $155.6 billion over the 2006-2010 period. The current rates for the five brackets are 10 percent, 25 percent, 28 percent, 33 percent, and 35 percent. Moving permanently to those rates would not affect revenues over the 2006-2010 period because the rates are current law (under EGTRRA). However, EGTRRA expires on December 31, 2010; thus, this option would reduce revenues over the 2006-2015 period by $566.6 billion.

All U.S. taxpayers saw their rates fall in 2001, and this option would maintain those cuts. However, under the first variant (make the 2002 rates permanent), individuals who had some income that was currently taxed in the 25 percent bracket would see their taxes rise over the 2006-2010 period. This variant would provide additional revenues but would raise marginal tax rates (the rate that applies to a taxpayer's last dollar of income). Higher marginal rates could discourage work and investment relative to the cuts scheduled in current law and thus constrain the level of U.S. economic activity.

An advantage of both variants is that by making some of EGTRRA's and JGTRRA's cuts permanent, they would simplify planning for the future. The scheduled expiration of the two laws' provisions after 2010 creates uncertainty among taxpayers about whether the Congress will change the law over the next few years. Some of that uncertainty could be mitigated by freezing tax rates at specified levels.

RELATED OPTION: Revenue Option 1

Revenue Option 5

Accelerate the Repeal of the Personal Exemption Phaseout and the Limit on Itemized Deductions

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	-2.4	-5.0	-3.8	-2.7	-1.5	-15.4	-123.5

Source: Joint Committee on Taxation.

To compute their taxable income, individuals subtract from their adjusted gross income (AGI) the amount of their personal exemptions and either the standard deduction or their itemized deductions. However, for high-income taxpayers, the tax code lessens the value of both personal exemptions and itemized deductions by gradually reducing how much of them those taxpayers can subtract when their AGI rises above specified income thresholds. The two phaseouts were enacted temporarily as part of the Omnibus Budget Reconciliation Act of 1990 and made permanent by the Omnibus Budget Reconciliation Act of 1993. Now, over the next several years, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) is gradually eliminating them. In 2006 and 2007, the impact of the phaseouts will be reduced by one-third; in 2008 and 2009, it will be reduced by two-thirds; and in 2010, the provisions will be repealed. However, under current law, the phaseouts are slated to return, in their pre-EGTRRA form, in 2011. The President, in his 2006 budget, has proposed the permanent repeal of the phaseouts.

This option would make the repeal permanent in 2006. Revenues under this option would fall by $2.4 billion in 2006 and $15.4 billion during the 2006-2010 period.

Phasing out the personal exemption reduces the exemption's value by 2 percent for each $2,500 of AGI above the income threshold. For 2005, the thresholds are $145,950 for single filers and $218,950 for married couples filing a joint return. Thus, single taxpayers whose AGI was $170,950 ($25,000 above the threshold) would lose 20 percent of the value of their personal exemption. In 2005, the value of personal exemptions phases out completely for single filers whose AGI is above $268,450 and joint filers whose AGI is above $341,450.

The limit on itemized deductions reduces them by 3 percent of the amount of AGI above a specific income threshold—$145,950 in 2005—which applies to all taxpayers. Thus, a taxpayer whose AGI was $245,950 would see his or her itemized deductions drop by $3,000, or 3 percent of the $100,000 in AGI above the threshold. Under current law, itemized deductions cannot be reduced by more than 80 percent.

Repealing the phaseouts of personal exemptions and itemized deductions would make the tax system less complex. Each phaseout provision requires taxpayers to perform numerous calculations to determine whether it applies to them and, if it does, to determine how the phaseout affects their taxable income. Repealing the provisions would increase economic efficiency by lowering marginal tax rates—the rate applied to the last dollar of income. (Currently, both provisions increase marginal tax rates over the portion of the income range that they affect and may thus reduce incentives to work and save.)

Because the tax system is progressive (rates rise with a taxpayer's income), exemptions and deductions are of greater value to higher-income taxpayers than to lower-income taxpayers. The current limits on itemized deductions and personal exemptions constrain that effect, increasing the progressivity of the tax system. Repealing the limits would therefore lessen that progressivity.

Revenue Option 6

Replace Multiple Tax Rates on Long-Term Capital Gains with a Deduction of 42 Percent

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.5	+3.1	+1.9	-3.7	+5.8	+7.6	-2.7

Source: Joint Committee on Taxation.

A taxpayer who sells an asset whose value has increased since it was purchased realizes a capital gain, which is generally subject to taxation. The gains realized on assets that are held for more than a year are taxed at lower rates than the rates that apply to ordinary income. Which capital gains tax rate applies to a gain depends on the year in which the gain is realized, the type of asset sold, how long it was held, and the taxpayer's other income—a level of complexity that requires taxpayers to make numerous calculations to figure their tax.

This option would simplify that process by allowing taxpayers to deduct from their taxable income 42 percent of their net realizations of long-term capital gains—whether or not they itemized their other deductions. Taxpayers who were subject to the alternative minimum tax (AMT) would adjust for that tax's lower rate structure by treating 34 percent of the deduction as income taxable under the AMT. Under this option, a taxpayer's actual rate on capital gains would be 58 percent of his or her marginal rate on ordinary income (the rate on the last dollar of income). In 2006, for example, someone in the 25 percent bracket for ordinary income would face a rate of 14.5 percent on gains. Someone in the 35 percent bracket would face a rate of 20.3 percent. The option, which was designed to be revenue neutral over the 2006-2015 period (under the assumption that it would be enacted at the end of 2005 and become effective January 1, 2006), would reduce revenues during those 10 years by a total of $2.7 billion. Because tax rates on capital gains under current law are lower through 2008 than in later years and because tax rates change abruptly at the outset of 2009 and 2011, the option would increase revenues by $7.6 billion in the first five years of the period through an irregular sequence.

Taxpayers face a variety of tax rates on capital gains. For example, a taxpayer who is in an individual income tax bracket of 25 percent or above and who sells stock owned for more than a year will pay 15 percent in taxes on the realized gain from now through 2008. Starting in 2009, he or she will pay 20 percent—unless the stock was purchased in 2001 or later and was held for at least five years. In that case, the applicable rate will be 18 percent. (An exception is original issues of stock of certain start-up businesses that are held for more than five years. Gains from those assets are taxed at an effective rate of 14 percent.) Taxpayers in the 10 percent or 15 percent brackets of the individual income tax face lower rates on gains until they realize enough to push their income past the 15 percent bracket.

Gains on many other assets are taxed at the same rate as gains on stocks, but there are exceptions. Ordinary income tax rates up to a maximum of 25 percent apply to some gains on depreciated real estate, and gains from the sale of gold, works of art, or other collectibles are taxed at ordinary rates of up to 28 percent. Taxpayers who are subject to the AMT face different rates on gains from the sale of collectibles and of original stock issues of certain start-up businesses.

The variety of rates forces taxpayers with long-term gains to make many calculations to determine their tax. On their 2004 returns, taxpayers with gains from most sales of assets or with qualifying dividends must figure their tax by completing a worksheet of 19 lines. If a taxpayer has a gain on a collectible or on depreciated real estate, he or she must instead complete a worksheet of 37 lines. Beginning in 2009, the forms will become even more complicated because different rates will be applied to certain gains on assets held for more than five years.

The main advantage of this option is that it would substantially lessen the burden of complying with the capital gains tax by reducing to two or three the number of lines that a taxpayer had to navigate at the end of Schedule D. In fact, that amount of extra calculation is the same as the amount required between 1942 and 1986, when the tax code excluded a portion of gains from taxpayers' adjusted gross income. The deduction under this option would be calculated much like the earlier exclusion was figured. Unlike the exclusion, however, it would not understate the income of taxpayers who had gains when eligibility for tax credits and other advantages intended for lower-income taxpayers was determined.

The main disadvantage of this option is that it would overturn several provisions of the tax code that some observers believe may improve economic efficiency (the allocation of resources to the use with the highest economic return), increase the equity of the tax system, or promote economic growth. In particular, separate capital gains rates would be eliminated for assets that were held for more than five years, issued by a start-up business, or classified as collectibles. Furthermore, all deductions for depreciation would be recaptured at ordinary tax rates instead of some benefiting from rates that were capped at 25 percent. Care is warranted, therefore, in weighing the advantages of those provisions against the benefits of simplification.

RELATED OPTIONS: Revenue Options 3, 8, and 12

RELATED CBO PUBLICATION: *Capital Gains Taxes and Federal Revenues*, October 2002

Revenue Option 7

Permanently Extend the Individual Income Tax Provisions of EGTRRA and JGTRRA

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues[a]	-11.5	-29.5	-37.2	-53.5	-56.3	-188.0	-1,507.9

Source: Joint Committee on Taxation.

a. Includes outlay effects.

The Congress has recently enacted three laws that substantially alter the individual income tax system: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and the Working Families Tax Relief Act of 2004 (WFTRA). EGTRRA reduced tax rates, created a new 10 percent tax bracket, increased the value of the child tax credit, provided relief from the marriage penalty and the alternative minimum tax (AMT), and made many smaller changes to the tax code. Originally, the main provisions of EGTRRA were scheduled to gradually phase in between 2001 and 2010; the entire law was slated to "sunset," or expire, in 2011. JGTRRA accelerated the phasing in of EGTRRA's rate reductions, marriage penalty relief, and larger child tax credit. It also further lessened the burden of the AMT and cut the tax rate on income in the form of capital gains and certain dividends. JGTRRA's speedup of the phased-in provisions is effective only for 2003 through 2005; after that, the provisions revert to the schedule established in EGTRRA. The lower rates on dividends and capital gains are in effect through 2008. WFTRA extended several of the provisions that had been accelerated under JGTRRA—specifically, the increased child tax credit, marriage penalty and AMT relief, and the 10 percent tax bracket—for various lengths of time.

This option would permanently extend the individual income tax provisions of both EGTRRA and JGTRRA. (A similar proposal has been advanced by the President as part of his 2006 budget.) Provisions that JGTRRA had accelerated would remain at their fully phased-in levels after 2005, and the remaining provisions of EGTRRA that are set to expire in 2011 would instead continue at the levels specified for 2010. The tax rates on dividends and capital gains would also be permanently extended.

The option would reduce revenues by $11.5 billion in 2006 and $188 billion over the 2006-2010 period.

In terms of the efficiency of the economy, the EGTRRA and JGTRRA provisions differ in their effects, but on balance, the benefits from lower marginal tax rates would probably be the most important. High tax rates distort people's economic decisions, encouraging taxpayers to shift income from taxable to nontaxable forms (for example, substituting tax-exempt bonds for other investments or tax-free fringe benefits for cash compensation). They also motivate people to increase spending on tax-deductible items such as home mortgage interest and charitable contributions. Lower tax rates reduce those distortions and allow investment to be allocated to the use with the highest economic return, thus leaving people better off.

Lower tax rates could also encourage people to work and save. However, the rates' ultimate effect on economic output would depend on whether countervailing changes were made elsewhere in the budget. Financing the tax cuts through increased deficits would reduce national saving and might offset the positive effects of lower tax rates on the number of hours worked in the economy and on private saving.

Permanently extending the two laws' individual income tax provisions would have mixed effects on the complexity of the tax system, whose simplification has been deemed a worthwhile objective. Some of the laws' provisions, such as relief from the alternative minimum tax, would simplify the tax code for some taxpayers. Other provisions, such as the one creating individual retirement accounts for education savings, would complicate it. The existing schedule for phasing in and phasing out the various provisions undoubtedly makes financial planning more difficult for many taxpayers. Making the provisions permanent would eliminate some of that uncertainty.

Equity, or fairness, is a key consideration in assessing tax policy, although evaluations of the fairness of permanently extending EGTRRA and JGTRRA might differ, depending on the metric used to measure fairness. If EGTRRA and JGTRRA were permanently extended, the nation's highest-income taxpayers would receive a large share of the overall tax reduction that the two laws would provide. But the share of the tax cut that each income group received would not be that different from the share of the overall income tax burden that they currently shoulder. As a result, permanently extending EGTRRA and JGTRRA would not much alter the shares of all income taxes now paid by the various income groups.

RELATED OPTIONS: Revenue Options 2, 4, 5, and 41

Revenue Option 8

Provide Relief from the Individual Alternative Minimum Tax

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues							
Index exemption amounts and brackets for inflation after 2006	-11.3	-30.9	-37.9	-46.3	-55.6	-182.0	-376.0
Allow some preferences	-18.4	-49.2	-59.1	-71.2	-83.9	-281.8	-529.2
Repeal the AMT	-21.9	-57.2	-66.2	-78.4	-91.5	-315.2	-582.5

Source: Joint Committee on Taxation.

Under current law, the individual alternative minimum tax (AMT), as its name implies, is an alternate method of computing federal income tax liability. A minimum tax was initially enacted in 1969 amid concerns that taxpayers with substantial income used tax preferences aggressively to reduce their tax liability to very low levels—in some cases, to zero. The Tax Reform Act of 1986 largely established the present form of the AMT; policymakers have modified it several times since that law was enacted.

To compute liability under the AMT, a taxpayer must add back several items to taxable income that are not regularly included in it, such as the deduction for state and local taxes, personal exemptions, and the standard deduction. Such adjustments also include tax preferences that only taxpayers with complex financial circumstances generally use—for example, the deduction for some intangible costs associated with drilling for oil and gas. Under the AMT, the total of those adjustments is replaced with an exemption—in tax year 2005, $40,250 for single taxpayers and $58,000 for married taxpayers filing a joint return—that phases out at higher levels of income. Taxpayers subtract the exemption from their income to arrive at their alternative minimum taxable income (AMTI). AMTI is taxed at two rates: 26 percent on the first $175,000 and 28 percent on the remainder. Taxpayers must pay the higher of their liability under the AMT or under the individual income tax. Additionally, they may not take certain tax credits if the credit will make their individual income tax liability lower than their AMT liability.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and the Working Families Tax Relief Act of 2004 (WFTRA) have temporarily increased the amounts of the AMT's exemption. Before EGTRRA, the exemption was $33,750 for single filers and $45,000 for joint filers. Under EGTRRA, those amounts increased to $35,750 and $49,000 for 2001 and 2002. JGTRRA increased the exemption further—to $40,250 and $58,000 for 2003 and 2004—and WFTRA extended that increase through 2005. In 2006, the exemption reverts to its pre-EGTRRA levels.

Unlike the schedule of tax brackets and exemptions for the individual income tax, the brackets and exemptions for the AMT are not indexed for inflation. As a result, growth of nominal income subjects more and more taxpayers to the alternative tax. For a given level of nominal income, a taxpayer's liability under the individual income tax will decline over time as the value of the standard deduction and personal exemptions increases with inflation. Moreover, the size of the lower tax brackets increases, so more income is taxed at lower rates. However, because liability under the AMT remains unchanged despite inflation, with time it will exceed liability under the individual income tax over a larger and larger portion of the income range.

Policymakers could choose one of several ways to modify the AMT and so provide some relief from its burden. One option would be to make permanent the relief provided by JGTRRA and index the AMT exemption and brackets for inflation after 2006. Under that alternative, 20 million taxpayers would move from the AMT back to the individual income tax in 2010 (the peak year), and revenues for the 2006-2010 period would fall by $182.0 billion. Another option would be to allow AMT-affected taxpayers to take the standard deduction, personal exemptions, and the deduction for state and local taxes—which would reduce the tax's rolls by 24 million in 2010 and cut revenues by $281.8 billion over the five-year period. A third approach would be to eliminate the AMT altogether. That option would shift 27 million taxpayers back to the individual income tax in 2010 at a cost in revenues of $315.2 billion over five years.

A primary benefit of all three of those alternatives would be simplification. Taxpayers who are now subject to the AMT or who are close to being affected by it must calculate their taxes twice. As the number of those taxpayers rises sharply, the overall complexity of the tax system will increase. Many of those taxpayers will be in the AMT's ranks not because they are sheltering a large amount of income but because they have many dependents or high state and local taxes. These options would simplify the tax system by reducing the number of taxpayers subject to the AMT. The first two alternatives would provide relief to taxpayers with simple returns but maintain the goal of preventing high-income taxpayers from using tax shelters to avoid income taxes. The third option, complete elimination, would reduce complexity the most.

Changing the tax code to provide some relief from the AMT could help preserve the intent of legislators who may not have anticipated the impact that an unindexed AMT would have on certain features of the tax system. For example, if the AMT is not modified, it will begin to limit the value of the standard deduction and personal exemption under the regular income tax. Those basic components will, by themselves, cause some taxpayers beyond those that policymakers originally intended to become subject to the AMT.

These options raise issues of fairness because this approach to tax simplification would primarily benefit higher-income taxpayers. A further consideration involves the effects of tax rates on incentives to work and save. Relief from the AMT would change the marginal tax rate (the tax rate on the last dollar of income) faced by taxpayers who are currently subject to the alternative tax. Some taxpayers would see their marginal rates increase under these options, which would tend to discourage people from working and saving, and others would see their rates decrease. On balance, more taxpayers would see a decrease in their marginal rate, which would tend to encourage them to work and save more. Relief from the AMT might further affect those incentives by reducing some taxpayers' tax burdens: a smaller tax liability would allow a person to achieve the same level of after-tax income with less income before taxes and so to some extent would discourage him or her from working more. How changes designed to restrict the reach of the AMT would, on balance, affect incentives to work and save is not clear; the impact would depend on taxpayers' relative sensitivity to those incentives.

RELATED OPTION: Revenue Option 7

RELATED CBO PUBLICATION: *The Alternative Minimum Tax*, April 2004

Revenue Option 9

Limit the Tax Benefit of Itemized Deductions to 15 Percent

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+29.3	+59.3	+60.5	+62.5	+64.7	+276.3	+966.1

Source: Joint Committee on Taxation.

Under current law, taxpayers may reduce their taxable income by the amount of their itemized deductions, which include state and local income and property taxes, interest payments on home mortgages, contributions to charity, employee business expenses, moving expenses, casualty and theft losses, and medical and dental expenses. Taxpayers benefit from itemizing if their deductions exceed the amount of the standard deduction. The tax code limits some itemized deductions (such as the one for medical expenses) to the amount in excess of a percentage of a taxpayer's adjusted gross income. In addition, a provision of the income tax law reduces all itemized deductions for high-income taxpayers. (However, under the Economic Growth and Tax Relief Reconciliation Act, or EGTRRA, that provision is scheduled to phase out between 2006 and 2010. It will revert to its original form in 2011 with EGTRRA's expiration.)

The benefit that taxpayers gain from itemizing deductions, like the benefit for all deductions, increases with people's marginal tax bracket (the bracket that applies to the last dollar earned). For example, $10,000 in itemized deductions reduces taxes by $1,500 for a taxpayer in the 15 percent bracket and by $3,500 for a taxpayer in the 35 percent bracket. Most taxpayers, however, do not itemize deductions. Of the one-third who do, about half are in tax brackets above 15 percent. This option would limit the tax benefit for those higher-bracket taxpayers to 15 percent of their itemized deductions. It would increase revenues by about $29.3 billion in 2006 and $276.3 billion over five years.

An advantage of reducing the benefit derived from itemizing deductions is that such an approach would lessen the incentive to spend more money on activities that are treated favorably for tax purposes than might be optimal for the most efficient allocation of society's resources. That incentive arises because the ability to deduct the costs of such activities—for example, contributions to a charity or interest on a mortgage for owner-occupied housing—effectively reduces the activity's after-tax price. The option's potential benefits for efficiency might be diminished, however, by the incentive that the option would also provide to convert itemized deductions into reductions in income. For example, taxpayers might liquidate some of their assets to repay mortgage loans, thus reducing both their income (from the assets) and their mortgage payments. Or they might choose to donate time or services to charities rather than cash.

The option would also alter relative tax burdens. Reducing the benefit that itemized deductions provide would raise average tax rates for many middle- and upper-income taxpayers. At the same time, individuals who incurred high levels of deductible expenses would bear larger tax burdens relative to those of people who had fewer such deductions. That outcome would go against the original rationale for making some of the items deductible, which was to help defray costs of an involuntary nature—such as casualty losses or business expenses—that reduced a taxpayer's ability to pay federal taxes.

Revenue Option 10

Limit the Mortgage Principal on Which Interest Can Be Deducted to $500,000

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+2.7	+3.0	+3.4	+3.8	+4.3	+17.2	+47.9

Source: Joint Committee on Taxation.

Historically, the tax code has treated investing in home ownership more favorably than it has treated other investments. One advantage is that the return from investing in one's own home is received as housing "services," which are not taxed; by comparison, the cash returns paid on most other direct investments (such as stocks, bonds, or an unincorporated business) must be included in taxable income. In other words, money invested in a home earns a tax-free return, whereas the return from money invested in most other assets is subject to tax.

A second advantage to home ownership is that home mortgage interest may be deducted from taxable income. With most other investments, when an investor borrows additional funds to complement his or her equity investment, the interest on that borrowing is deductible only up to the amount of taxable return that the project earns. Allowing the deduction of mortgage interest on one's home when the return on the home is not taxed effectively subsidizes, by the amount of the tax savings, the cost of borrowing against one's home.

Current law limits deductions of the interest on large mortgages. Taxpayers may deduct interest on up to $1 million of debt that they have incurred to buy, build, or improve first or second homes. They may also deduct interest on up to $100,000 of other loans that they have secured with a home (for example, a home-equity loan), regardless of the loan's purpose.

This option would reduce the amount of principal eligible for the mortgage interest deduction from $1 million to $500,000. In 2006, that cut would trim deductions for 700,000 taxpayers with large mortgages and increase revenues by $2.7 billion. In 2010, it would pare deductions for 1.3 million large-mortgage taxpayers and increase revenues by $4.3 billion. Taxpayers subject to the limit would account for less than 1 percent of all homeowners and about 3 percent of new buyers. The number of people affected would be greatest in high-cost areas, such as Honolulu, Los Angeles, New York City, and San Francisco.

Owners who had enough other wealth to reduce their mortgage debt to the $500,000 limit could avoid paying additional taxes and so retain their tax advantage at its current level. Experience in Great Britain, Canada, and Australia—countries that allow little or no deduction for mortgage interest—suggests that many affected owners could reduce their mortgage borrowing to the option's lower limit.

The deduction for mortgage interest contributes to the incentive to become a homeowner for people who need to borrow to buy a home and who benefit from itemizing their deductions. The deduction also encourages people to purchase larger homes than they would otherwise have bought. Increasing home ownership, advocates say, contributes to social and political stability by strengthening people's stake in their communities and governments. In addition, home ownership may bolster neighborhoods because it makes moving more difficult and motivates people to maintain their homes. Individuals typically will not consider those benefits to the community when deciding whether to rent or own, so a subsidy to promote home ownership may tilt people's decisions in the direction of the community's interest.

Limiting the deductibility of interest to the amount on loans of $500,000 would still leave the purchasers of more expensive homes with a sizable incentive to become homeowners: at a mortgage rate of 6 percent, they could deduct up to $30,000 of interest. Most people with the financial means to buy a home that costs more than $500,000 are likely to conclude that that incentive, along with the remaining tax advantages and other benefits of ownership, is a sufficient reason to make the purchase. (Indeed, Canadians, who have no such incentive, achieve about the same rate of home ownership as do people in the United States.)

Lessening the inducement to borrow for home purchases could direct more savings to investments in business enterprises whose returns were taxable and, in some cases, to investments in education and training. About 35 percent of net private investment since 1980 has gone into owner-occupied housing. Consequently, less investment in owner-occupied housing, even just within the market for larger homes, could noticeably boost investment in other sectors and increase the nation's productivity.

An abrupt lowering of the amount of interest that could be deducted might have adverse effects that could be ameliorated by phasing in this option. A sudden drop would reduce home values, mortgage lending, and home building at the top end of the housing market. By contrast, gradually reducing the limit would allow more time for all of the market's participants to adjust. In growing areas, prices would eventually return to more typical levels as rising incomes and population brought back the demand for larger homes. In areas without growth, the cuts in prices could be long-lasting. If price reductions persisted, current owners who had to sell to move elsewhere would be hurt, but new buyers in the area would be helped.

The administration of the existing limits on mortgage interest deductions or of the limit under this option could be simplified by directly capping the amount of interest that could be deducted. With that approach, homeowners would not need to distinguish between the amounts they borrowed that were used to buy, build, or improve a first or second home versus the money they borrowed for other purposes. The Internal Revenue Service could enforce such a limit simply by comparing the deductions that taxpayers claimed with the amount of mortgage interest reported by their lender (or lenders). Limiting the deduction of mortgage interest would, however, shift more of the burden of changes in interest rates onto home buyers and away from the government. For example, if the interest deduction was limited to $30,000—the amount that a homeowner with a loan of $500,000 and an interest rate of 6 percent could deduct in the first year—and interest rates rose to, say, 12 percent, a person taking out a new $500,000 mortgage would pay $60,000 in interest but still only deduct $30,000 from taxable income.

RELATED OPTIONS: Revenue Options 9, 11, and 12

Revenue Option 11

Limit Deductions of State and Local Taxes to the Amount Exceeding 2 Percent of Adjusted Gross Income

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+2.9	+11.5	+11.6	+11.6	+12.0	+49.6	+170.2

Source: Joint Committee on Taxation.

In determining their taxable income, taxpayers may either claim a standard deduction or itemize certain expenses and deduct them from their adjusted gross income (AGI). Such expenses include state and local taxes on income, real estate, and personal property. The Working Families Tax Relief Act of 2004 (WFTRA) changed the treatment of state and local sales taxes, which previously were not deductible. Under WFTRA, taxpayers now have the option, in 2004 and 2005, of deducting either their state and local sales taxes or their state and local income taxes.

For taxpayers who itemize, those deductions are essentially a federal subsidy for state and local tax payments. As such, the deductions indirectly help support increased spending by state and local governments at the expense of other uses of federal revenues. This option would establish a floor for deductions of state and local tax payments, limiting them to the amount in excess of 2 percent of a taxpayer's AGI.

One of the arguments made for allowing taxpayers to deduct state and local tax payments is that the practice helps lessen the effect of differences in taxes among the states. This option would continue some of that mitigating effect and increase federal revenues by about $49.6 billion over the 2006-2010 period. An alternative approach would be to prohibit deductions for payments above a fixed ceiling, which might also be a percentage of AGI. A ceiling of 6.05 percent of AGI, for example, would increase revenues by about the same amount. However, a floor and a ceiling would have very different effects on the incentive that the current deduction now provides for state and local governments' spending. A floor would reduce that incentive by very little, whereas a ceiling would reduce it to a substantial degree.

As a way to assist state and local governments, the deductibility of state and local taxes has several disadvantages. First, it benefits only taxpayers who itemize their expenses and not people who claim the standard deduction. Second, because the value of an additional dollar of deductions increases with the marginal tax rate (the rate on the last dollar earned), the deductions are worth more to taxpayers in higher income tax brackets than to those in lower brackets. Third, deductibility favors wealthier communities, which have more residents who itemize than lower-income communities have. Because deductibility benefits only people who itemize and wealthier communities have a greater proportion of such taxpayers, public spending in those localities receives a bigger federal subsidy. Fourth, deductibility may deter states and localities from financing services with nondeductible user fees, thereby discouraging more-efficient pricing of some services.

One argument against restricting deductibility is based on equity. A taxpayer with a large liability for state and local taxes is less able to pay federal taxes than a taxpayer with the same total income and a smaller state and local tax bill. In some localities, however, a taxpayer who pays higher state and local taxes may also benefit from more publicly provided services, such as recreational facilities. That equity-based argument presumes that taxpayers do not benefit from spending by state and local governments, yet much of that spending is for goods and services that are consumed by all taxpayers. In effect, such collectively consumed goods are analogous to private consumption, the costs of which are not deductible.

Revenue Option 12

Limit Deductions for Charitable Giving to the Amount Exceeding 2 Percent of Adjusted Gross Income

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+6.4	+16.5	+17.8	+19.2	+20.6	+80.5	+208.9

Source: Joint Committee on Taxation.

Current law allows taxpayers who itemize to deduct the value of contributions they make to qualifying charitable organizations up to a maximum of 50 percent of their adjusted gross income (AGI) in any year. The deduction thus lowers the after-tax cost of donating and so provides an incentive to contribute to charitable enterprises. In 2001, $139 billion in charitable contributions was claimed on 39.4 million tax returns.

This option would limit the deduction for such contributions but retain a tax incentive for donating by allowing taxpayers to deduct only contributions that exceed 2 percent of their AGI. That approach would increase revenues by about $6.4 billion in 2006 and about $80.5 billion over the 2006-2010 period.

An argument for this option could be made on the basis of efficiency—that is, as a way to improve the allocation of society's resources. Some types of "goods" in a society are collectively consumed (an example is national defense); others (such as apples) are privately consumed. Because collectively consumed goods tend not to be provided in the private market, they are often supplied by nonprofit organizations, and the deduction for charitable contributions provides an incentive to taxpayers to support those organizations. But the deduction may provide too much encouragement—in which case nonprofit organizations will be supported to a greater extent than is desirable for the sake of efficiency. If itemizers who donate less than 2 percent of their income to such organizations tend to receive too much of an incentive for such gifts, then this option could reduce contributions to a more efficient level.

Under this option, however, total charitable giving would decline. The option would remove the incentive to donate for people whose contributions did not exceed the 2-percent-of-AGI threshold, and many of those taxpayers would reduce their contributions. People whose contributions exceeded the threshold would still have an incentive to give but would have slightly lower after-tax income (because of the smaller deduction), which could lead them to reduce their contributions by a small percentage. (That percentage reduction would probably be smaller than the drop for people whose contributions did not exceed the threshold.) In addition, establishing a floor of 2 percent for contributions would encourage taxpayers who planned to make gifts over several years to lump them together in one tax year to qualify for the deduction.

RELATED CBO PUBLICATIONS: *The Estate Tax and Charitable Giving*, July 2004; and *Effects of Allowing Nonitemizers to Deduct Charitable Contributions*, December 2002

Revenue Option 13

Eliminate the Exclusion for Employer-Sponsored Dependent Care and the Child and Dependent Care Credit

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.7	+2.7	+2.6	+2.6	+2.5	+11.1	+23.0

Source: Joint Committee on Taxation.

The tax system provides two types of assistance for working taxpayers who incur expenses for child and other dependent care: a tax exclusion (the amount of the expenses are "excluded" from the income paid to an employee for the purpose of calculating taxable income) or a tax credit, which is available only to people who do not use the employment-based exclusion. Eliminating both subsidies would increase revenues by $0.7 billion in 2006 and $11.1 billion from 2006 through 2010.

To receive the tax exclusion, a taxpayer's employer must either provide child or dependent care directly or establish a qualified plan for offering it. As much as $5,000 in child and dependent care expenses may be excluded from the taxable wages of employees. The maximum amount of the exclusion is limited to a taxpayer's earnings or, in the case of married taxpayers, the wages of the lower-earning spouse.

Taxpayers who do not receive employment-based subsidies may claim a nonrefundable credit against their income tax. The credit is limited to expenses of $3,000 for one dependent and $6,000 for two or more dependents. As with the exclusion, the total amount of qualifying expenses may not exceed the earnings of the taxpayer or, in the case of a couple, those of the lower-earning spouse. The rate of the credit per dollar of qualifying expenses starts at 35 percent for taxpayers whose adjusted gross income (AGI) is $15,000 or less; it phases down to 20 percent for taxpayers whose AGI is $43,000 or more. For most taxpayers, the applicable credit rate is 20 percent, which results in a maximum credit of $600 for one dependent and $1,200 for two or more dependents. The current parameters of the child and dependent care credit were established in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). If EGTRRA "sunsets" (expires) as scheduled in 2011, both the amount of allowable expenses and the rate structure of the credit will revert to their lower, pre-EGTRRA levels.

Even though the credit and the exclusion subsidize the same activities, they provide significantly different benefits. For example, a high-income taxpayer with one child may receive an income tax reduction of up to $1,750 under the employment-based exclusion but only $600 under the credit. In addition, the exclusion reduces payroll taxes; the credit provides no such benefit.

A fairer tax system could be one positive outcome of this option. Both subsidies offer a benefit that is unavailable to taxpayers who have no children or other dependents or who stay at home to provide care. Taxpayers who are alike in other respects therefore face unequal tax burdens depending on whether or not they have dependents and on how they care for them. A tax system without subsidies for child and dependent care would treat all taxpayers similarly and would be less complex (because it would simplify taxpayers' calculations of their tax).

Yet eliminating the exclusion might be inappropriate if dependent care was considered to be part of the cost of employment. The tax code permits some other employment-related expenses to be excluded from a person's income. Moreover, research has shown that how much the secondary earner in a couple works—that is, the spouse with the lower of the two incomes—is particularly sensitive to tax rates. Both the exclusion and the credit lower the cost of working for taxpayers who care for dependents. Presumably, a secondary worker who stopped working would care for the dependents rather than pay someone else to do it. Consequently, eliminating those subsidies might lessen the labor force participation of those spouses.

Revenue Option 14

Include Employer-Paid Life Insurance in Taxable Income

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+1.2	+2.0	+2.1	+2.2	+2.2	+9.7	+22.4

Source: Joint Committee on Taxation.

Many workers receive part of their compensation in the form of noncash employer-paid benefits that are not subject to either income or payroll taxes. For example, current law excludes from taxable income the premiums that employers pay for employees' group term life insurance, although it limits the amount that can be excluded to the cost of premiums for the first $50,000 of insurance. (Self-employed people cannot exclude their premiums.) Of the noncash benefits that offer their recipients a tax advantage relative to compensation in cash, employer-paid life insurance is the third most expensive (after health insurance and pensions) in terms of diminished federal revenues. If premiums for employer-paid life insurance were included in employees' taxable income, as would occur under this option, individual income tax revenues would rise by $5.7 billion from 2006 through 2010, and payroll tax revenues would increase by $4 billion.

Excluding life insurance premiums from taxation has ramifications for both the efficiency and equity of the tax system. Like the tax exclusions for other employment-based noncash benefits, the exclusion for life insurance premiums creates an incentive that could induce people to purchase more life insurance than they would have bought if they had had to pay the full cost of it themselves. Furthermore, excluding premiums from taxation allows workers whose employers purchase life insurance for them to pay less tax than workers who have the same total compensation but must purchase such insurance on their own.

Those factors, which argue in favor of this option, are reinforced by the relative ease with which the option could be implemented. The value of employer-paid life insurance, unlike the value of some other noncash benefits, can be accurately measured. As a result, employers could report the insurance premiums they paid for each employee on the employee's W-2 form and compute withholding in the same way as is done for wages. Indeed, employers already withhold taxes on the life insurance premiums they pay that fund death benefits above the $50,000 limit.

Yet a tax incentive to purchase life insurance might be called for in certain circumstances. One such case might be if people bought too little life insurance because they systematically underestimated the potential financial hardship that their death might bring to their families. But even if too little life insurance was purchased in the absence of the tax exclusion for premiums, a more efficient way of encouraging people to buy insurance might be to extend the favorable tax treatment to all purchasers and avoid favoring only people whose insurance was provided by their employers.

Revenue Option 15

Limit the Tax Exclusion of Employer-Paid Health Insurance Premiums

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+17.5	+30.3	+38.8	+48.6	+59.9	+195.1	+705.9

Source: Joint Committee on Taxation.

Employer-paid health insurance premiums, though part of many employees' total compensation, are exempt from payroll tax under FICA (the Federal Insurance Contributions Act) and from the individual income tax. For 2004, that exclusion from taxation will reduce revenues by a total of about $145 billion. In addition to the exclusion of premiums paid by their employer, current law offers employees another tax advantage: spending from employer-sponsored flexible spending accounts (FSAs) and health savings accounts (HSAs) is also tax-exempt.

This option would limit the exclusion from taxation of both that income and of employer-paid health insurance premiums. Specifically, it would treat as taxable income for employees any contributions that employers or employees made for health insurance and health care costs (through accounts such as FSAs) that together exceeded $720 a month for family coverage and $310 a month for individual coverage. (The one exception would be individuals' contributions to HSAs, which would not be affected. HSAs may be used for health expenses but not insurance premiums.) The two ceilings, which are based on average premiums paid by employers in 2004, would not be indexed for inflation.

Over the 2006-2010 period, the option would increase income tax and payroll tax revenues by $195.1 billion. Including employers' contributions for health care coverage in the Social Security wage base, however, would also increase future outlays for Social Security benefits over the long run.

A major advantage of eliminating the tax preference that encourages health insurance coverage above the ceilings is that such a change could make the markets for health insurance and health care more efficient. The two markets are closely linked. Current tax law provides incentives for health insurance plans to cover routine expenses in addition to large, unexpected costs, because those routine charges are subsidized only if they are paid through the insurance plan. That factor can drive up health care costs. Under this option, employees and their employers would have an incentive to economize, which could reduce upward pressure on health care prices and encourage the use of cost-effective types of medical care.

The option would have other benefits as well. It would reduce the incentive that firms have to offer special health care packages for top executives. In addition, it would create a more level playing field between employer-provided and other forms of health insurance, which might lead to a greater range of choices in the market for individual health insurance coverage. (The President's budget request for 2006 includes a provision that addresses that same issue, but rather than limiting tax benefits to employer-paid health insurance premiums, it would extend tax benefits to the purchase of health insurance by individuals.) If, as a result, health insurance was less likely to be tied to employment, the rates of coverage among people who were out of work or between jobs might be improved. Furthermore, since the ceilings would not be indexed to inflation, the benefits noted here would increase over time, as the tax exclusion effectively phased out. (The Congress has already limited the tax exclusion for employer-paid group term life insurance in a similar way.)

The option would, however, have some drawbacks. The fixed dollar limits would have disparate effects on employers. For example, the additional costs would be greatest for areas where health care was more expensive and for firms that offered generous health benefits. Limiting the subsidy for employer-paid insurance premiums would probably result in employees directly paying a larger share of the premiums, which might induce some workers to forgo health insurance. Alternatively, the option might lead some firms to discontinue offering health insurance coverage. (However, firms that chose that course would pay higher wages or offer other benefits—in order to stay competitive in the labor market.)

RELATED CBO PUBLICATIONS: *How Many People Lack Health Insurance and For How Long?* (paper and brief), May 2003; and *Tax Treatment of Employment-Based Health Insurance* (testimony by Rosemary D. Marcuss, Assistant Director for Tax Analysis, before the Senate Finance Committee), April 1994

Revenue Option 16

Include Investment Income from Life Insurance and Annuities in Taxable Income

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+10.9	+22.1	+22.7	+23.3	+23.9	+102.9	+244.1

Source: Joint Committee on Taxation.

Life insurance policies and annuities often combine features of both insurance and tax-favored savings accounts. (An annuity is a contract with an insurance company under which a person pays a single premium, or a series of premiums, and the company provides a series of fixed or variable payments to that person at some future time, usually during retirement.) The investment income from the money paid into life insurance policies and annuities, sometimes called inside buildup, is not taxed until it is paid out to the policyholder. If that accumulation is left to the policyholder's estate or used to finance life insurance (in the case, for example, of whole-life policies), it can escape taxation entirely. The tax treatment of inside buildup is similar to the treatment of capital gains.

Under this option, life insurance companies would inform policyholders annually—just as mutual funds do now—of the investment income that had been realized on their account, and people would include those amounts in their taxable income for that year. With that change, disbursements from life insurance policies and benefits from annuities would no longer be taxable when they were paid. The tax treatment of investment income under this option would match the treatment of income from a bank account, taxable bond, or mutual fund. Making such investment income taxable as it was realized would increase revenues by $10.9 billion in 2006 and a total of $102.9 billion from 2006 through 2010. By comparison, tax on the investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be deferred until benefits were paid.

By taxing the investment income from life insurance policies, this option would eliminate a tax incentive to buy life insurance, which might or might not be a useful plan. Encouraging purchases of life insurance would be useful if people systematically underestimated the financial hardship that their death would impose on spouses and families. That lack of foresight could cause them to buy too little life insurance or, similarly, too little annuity insurance to protect themselves against outliving their assets. Little evidence exists about how successful the current tax treatment is in reducing underinsurance.

A drawback of using tax-deferred savings as an incentive to purchase life insurance is that it provides no inducement to purchase term life insurance (because term insurance has no savings component). Under the assumption that some incentive to purchase insurance would, indeed, be a useful tool, an alternative approach might be to directly encourage people to purchase life insurance by giving them a tax credit for their insurance premiums or by allowing them to take a partial deduction for the premiums. (Annuities already receive favorable tax treatment through special provisions for pensions and retirement savings.)

RELATED OPTION: Revenue Option 14

Revenue Option 17

Include in Adjusted Gross Income All Income Earned Abroad by U.S. Citizens

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+0.9	+4.1	+4.3	+4.5	+4.7	+18.5	+46.1

Source: Joint Committee on Taxation.

U.S. citizens who live abroad are required to file a tax return but may exclude from taxation some of the income they earn overseas—in 2005, up to $80,000 for single filers and as much as $160,000 for qualifying married couples. That tax exclusion, along with one for foreign housing and the usual personal exemptions and deductions, means that Americans residing abroad and earning close to $100,000 may not incur any U.S. tax liability, even if they pay no taxes to the country in which they reside. Moreover, U.S. citizens with foreign-earned income above the exclusion amount receive a credit for taxes that they pay to foreign governments. The credit may eliminate tax liability on that income under the U.S. tax system.

This option would retain the credit for taxes paid to foreign governments but would require U.S. citizens who resided overseas to include in their adjusted gross income all of the income they earned abroad. Thus, under the option, Americans living in foreign countries that had tax rates higher than those in the United States would generally not owe U.S. tax on their earned income, whereas those living in relatively low-tax countries could have some U.S. tax liability. The option would increase revenues by $0.9 billion in 2006 and $18.5 billion over the 2006-2010 period.

Proponents and opponents of this option differ on issues of equity and efficiency. Proponents argue that U.S. citizens should pay U.S. taxes under this country's tax system because they still receive the benefits of citizenship, even as foreign residents. Supporters of the option also maintain that U.S. citizens with similar income should incur similar tax liabilities, regardless of where those citizens live, and they note the unfair advantage gained by individuals who move to low-tax foreign countries to escape U.S. taxation yet retain their American citizenship. Proponents also point out that the existing provision could be viewed as a subsidy to corporations that employ U.S. citizens abroad—because the corporations can pay those employees less than they would pay them in the United States to earn the same after-tax income. Moreover, eliminating the exclusion for foreign-earned income would lessen the complexity of the tax code.

By contrast, opponents of this option note that U.S. citizens who live in other countries do not receive the same services that U.S. residents receive from their government. They also argue that the exclusion of foreign-earned income makes it easier for U.S. multinational firms to find American employees who are willing to live and work abroad.

Revenue Option 18

Include Social Security Benefits in Calculating the Phaseout of the Earned Income Tax Credit

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues[a]	*	+0.2	+0.2	+0.2	+0.2	+0.8	+2.0

Source: Joint Committee on Taxation.

Note: * = added revenues of less than $50 million.

a. Includes outlay savings.

Under current law, the earned income tax credit (EITC) phases out as the larger of a taxpayer's earned income or adjusted gross income (AGI) exceeds a certain threshold. The tax code, however, excludes most income from government transfer programs (such as Social Security) from a person's AGI. Consequently, low-income families that receive sizable transfer payments can claim the EITC with the same total income that will reduce or deny the credit to otherwise comparable families who include all of their income in their AGI. The tax code already requires some Social Security benefits to be counted as income: up to 85 percent of any benefits received by single taxpayers with income above $25,000 or by joint filers with income above $32,000 must be included in AGI. This option would require taxpayers to include all Social Security benefits in a modified AGI that would be used for phasing out the EITC. The change would increase federal revenues and decrease outlays for the credit by $800 million over the 2006-2010 period.

One argument in support of this option is that if it was implemented, it would make the EITC fairer. Counting all Social Security benefits in calculating the credit's phaseout would give the same EITC to low-income taxpayers who receive such benefits and claim the credit as that given to otherwise comparable taxpayers whose income is derived entirely from sources that are fully included in their AGI. In addition, because the Internal Revenue Service (IRS) already receives information on taxpayers' Social Security benefits, the administration of this option would require only minor procedural changes.

But under this option, some income from transfers would still be excluded from the modified AGI. Hence, the option would not completely resolve the problem that families with the same total income might receive different credits. The IRS currently does not collect information on most forms of taxpayers' transfer income other than Social Security benefits. As a result, requiring taxpayers to count all such income would substantially expand the information reported to the IRS, markedly increasing both taxpayers' costs of compliance (for example, time spent filling out forms)and the IRS's administrative costs. Furthermore, because most transfer income that is not included in a taxpayer's AGI is from means-tested programs (which tie an individual's eligibility for benefits to a test of need based on income and assets), counting all transfers in phasing out the EITC would offset, at least in part, the goal of providing support to low-income recipients.

Another consideration is that counting Social Security benefits in phasing out the EITC would increase the costs of compliance for Social Security recipients who claimed the credit. Moreover, it would further complicate the already complex form such taxpayers must complete. Those outcomes would run counter to recent efforts to simplify the procedures for claiming the earned income tax credit.

Revenue Option 19

Substitute a Tax Credit for the Exclusion of Interest Income on State and Local Debt

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.3	+0.6	+0.9	+1.4	+1.7	+4.9	+18.6

Source: Joint Committee on Taxation.

The tax code allows owners of state and local bonds to exclude the interest they earn on that debt from their gross income and thus from income taxation. As a result, state and local governments pay lower rates of interest on such bonds than would be paid on bonds of comparable risk whose interest was taxable. The revenues that the federal government forgoes each year exceed $32 billion and effectively pay a portion of the costs that state and local governments incur when they borrow.

This option would replace the exclusion of interest income from new issues of state and local debt with a tax credit that, unlike most credits, would be included in taxpayers' adjusted gross income. Under the option, a bondholder would receive a taxable interest payment from the state or local government that issued the bond plus a federal tax credit that would give the bondholder an after-tax return that was comparable to the return provided by a tax-exempt bond. The option would retain restrictions (such as those on arbitrage earnings) that now apply to the issuance of tax-exempt bonds by state and local governments. It would increase revenues by $0.3 billion in 2006 and $4.9 billion over the 2006-2010 period.

Switching to a tax credit rather than continuing to exclude the interest paid on state and local debt from the gross income of bond purchasers would have several positive features. It could reduce the borrowing costs of state and local governments by a percentage similar to the reduction that the tax exclusion now provides but with a smaller reduction in federal revenues. (The drop in revenues would be smaller because switching to a credit would eliminate gains that bondholders in higher tax brackets receive that exceed the investment return necessary to induce them to buy the bonds.) Another argument for switching to a tax credit is that its size could be varied to allow the Congress to adjust the extent of the federal subsidy—on the basis of its perceived benefit to the public—for different categories of state and local government borrowing. However, substituting a tax credit for the exclusion would keep the federal subsidy akin to an entitlement; that is, it would not automatically be subject to annual Congressional scrutiny.

Another effect of switching to a tax credit is that it might raise the interest rate that state and local governments pay to borrow. For example, it would lower the bonds' after-tax returns for people who are subject to higher marginal tax rates and thus lead them to buy fewer bonds. (The marginal rate is the rate on the last dollar of income.) If that drop in demand for bonds was not offset by increased demand from other investors, the cost of state and local governments' borrowing would be reduced by a smaller percentage than it currently is, and interest rates on state and local debt would rise. Paying higher rates for borrowing could lead state and local governments in turn to reduce their spending on capital facilities.

RELATED CBO PUBLICATION: *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures*, July 2004

Revenue Option 20

Tax Social Security and Railroad Retirement Benefits Like Private Pensions

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+9.0	+22.1	+23.3	+24.1	+25.1	+103.6	+279.2

Source: Joint Committee on Taxation.

Under current law, most benefits from the Social Security and Railroad Retirement programs are treated preferentially—that is, they are not subject to taxation. Recipients pay tax only if the sum of their adjusted gross income, their nontaxable interest income, and one-half of their Social Security and Tier I Railroad Retirement benefits exceeds a fixed threshold. If that total is more than $25,000 for a single taxpayer or $32,000 for a couple filing jointly, up to 50 percent of the benefits are taxed. Above a second set of thresholds—$34,000 for single and $44,000 for joint filers—as much as 85 percent of the benefits are taxed. Together, those levels constitute a three-tiered structure for taxing benefits.

Distributions from private pension plans are taxable unless those payments represent the recovery of an employee's after-tax contributions, or "basis." Each year, a certain percentage of a recipient's distribution is deemed to be nontaxable basis recovery. That percentage, which is determined in the first year in which distributions begin, is based on the cumulative amount of after-tax contributions and the recipient's life expectancy. Once the individual has recovered his or her entire basis tax-free, all subsequent distributions are fully taxed.

A basis exists for Social Security and Railroad Retirement recipients as well, because employees pay 50 percent of the payroll taxes that support those programs out of their after-tax income. (A basis also exists for self-employed people, who pay 100 percent of payroll taxes but who can deduct only half of those payments on their income tax returns.) This option would tax all Social Security and Railroad Retirement benefits in excess of that basis, which could be recovered in the same manner as that applied to private pensions. Under such an approach, the percentage of benefits subject to tax would exceed 85 percent for the overwhelming majority of recipients, and revenues would increase by $103.6 billion between 2006 and 2010.

This option would make the tax system more equitable in at least two ways. First, it would eliminate the preferential treatment that the tax code now accords to Social Security benefits but not to private pension benefits—both the slight preference given to higher-income taxpayers and the much larger preference accorded to low- and middle-income taxpayers. Second, it would treat elderly taxpayers in the same way that nonelderly taxpayers with comparable income are treated. In addition, the option would make preparing tax returns for elderly people substantially simpler.

Set against the option's seemingly positive features, however, are several drawbacks. One is that more elderly people would have to file tax returns than now file under current law. In addition, retirees might feel that an increase in taxes on benefits violates the implicit promises of the Social Security and Railroad Retirement programs. Furthermore, calculating the percentage of each recipient's benefits that is to be excluded from taxation would impose an additional burden on the Social Security Administration.

RELATED CBO PUBLICATION: *Social Security: A Primer,* September 2001

Revenue Option 21

End the Preferential Treatment of Dividends Paid on Stock Held in Employee Stock Ownership Plans

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.5	+1.0	+1.1	+1.1	+1.2	+4.9	+12.6

Source: Joint Committee on Taxation.

Employee stock ownership plans (ESOPs) are a form of retirement plan that provides more tax advantages than do other qualified plans. Employers' contributions to ESOPs are typically in the form of company stock, and employers can deduct such contributions, like those made to other qualified retirement plans, from their firms' taxable income. But employers with ESOPs have an additional tax advantage relative to those without such arrangements in that they may also deduct the dividends paid on stock held in an ESOP if:

- The dividends are paid directly to the ESOP's participants;
- The dividends are paid to the plan itself but distributed to the participants within 90 days of the end of the plan year;
- The dividends are paid to the plan but reinvested in additional company stock; or
- The dividends are paid to the plan and used by it to repay loans with which the stock was originally purchased.

Another advantage associated with ESOPs is that the tax on capital gains from the sale of the sponsoring company's stock to such a plan can be deferred, under certain circumstances. Among the conditions that must be met are the following:

- The stock cannot be publicly traded;
- The sponsoring company must be a subchapter C corporation (that is, subject to the corporate income tax); and
- The proceeds of the sale must be invested in the stock of another U.S. company.

Eliminating the tax advantages that are now accorded to ESOPs—which in effect would render them indistinguishable from other qualified retirement plans—would increase revenues by $4.9 billion between 2006 and 2010.

ESOPs were designed to encourage a corporation and its shareholders to contribute or sell stock to the company's employees. A rationale for retaining the tax advantages of ESOPs is that employees' ownership of stock directly links their financial interests to their productivity. That is, greater productivity translates into higher profits for the company and thereby increases the value of the employees' stock. To the extent that the incentive of stock ownership works as intended, ESOPs help promote increased productivity among workers.

Several arguments, however, can be mustered against the preferential tax treatment of ESOPs. First, it results in similar dividend payments having different tax consequences for different companies, and the rationale for such disparate treatment—namely, a link between employees' ownership of their company's stock and their productivity—has not been clearly established. Second, it hinders the diversification of employees' retirement portfolios because the assets of an ESOP, by design, consist primarily of shares of the employer's stock. If the price of the company's stock dropped, employees' wealth in retirement might be substantially less than if they had been permitted to diversify their investments—as participants in a typical 401(k) retirement plan can. A third argument against retaining the preferential tax treatment accorded to ESOPs is that the plans have occasionally been used for purposes for which they were not intended. (For example, they can be used to ward off hostile takeovers by placing large numbers of shares in friendly hands.)

Revenue Option 22

Disallow Further Deductible Contributions to Traditional IRAs, But Allow Contributions of $5,000 to Roth IRAs Regardless of Income

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+2.5	+5.5	+5.9	+5.1	+3.5	+22.5	+23.4

Source: Joint Committee on Taxation.

Under current law, most employed individuals and their spouses may contribute up to $4,000 annually (more, if they are age 50 or older) to either a traditional individual retirement account (IRA) or a Roth IRA. The limits are scheduled to increase to $5,000 by 2008 and then drop to $2,000 in 2011. If neither the contributor nor the contributor's spouse is covered by an employer's pension plan or if their combined income is below certain thresholds, their contributions to traditional IRAs may be deducted from their gross income—and thus are not taxed when they are made. When those contributions are withdrawn, however, they and any earnings on them are fully taxable. (Because people benefit from the tax advantages of traditional IRAs at the front end of the process—namely, when the contributions are made—such plans are sometimes called front-loaded.)

In contrast, contributions to Roth IRAs (which are limited to taxpayers whose income falls below certain thresholds) are never deductible—but neither are withdrawals from those accounts taxable. (Because the tax advantages of Roth IRAs are realized at the back end of the process—when the funds are withdrawn—such plans are sometimes referred to as back-loaded.) Owners of traditional IRAs whose income is below $100,000 can convert their traditional account to the Roth format but must pay tax on the converted amount.

This option (which is similar to the proposal for retirement savings accounts in the President's budget request for 2006) would disallow any further contributions to traditional IRAs, remove the income restrictions on contributions to Roth IRAs, immediately (and permanently) increase the limit on contributions to Roth accounts to $5,000, and begin indexing that limit for inflation. The income restrictions on conversions to Roth accounts would also be removed, and people who converted their traditional IRAs during the first year that the option was in effect would be allowed to spread their resulting tax liability over four years. The option would increase revenues by $22.5 billion between 2006 and 2010 but only by $0.9 billion between 2011 and 2015.

The increase in revenues in the early years in which the option was in effect would come from the taxes paid on conversions and the immediate loss of tax deductions by people who currently contribute to traditional IRAs. However, that increase would be temporary. Most conversions of traditional IRAs would occur in the first possible year following the option's implementation because taxes on the accounts' contributions could be prorated over the next four years. After that, revenues from that source would drop sharply. Furthermore, the value of not permitting tax deductions for contributions to IRAs would plunge beginning in 2011, when the limits on contributions revert to $2,000. That scheduled reduction in the limit on contributions, combined with the loss in revenues from no longer taxing withdrawals, would result in reduced revenues after the eighth year—which is why the 10-year increase in revenues ($23.4 billion) is virtually the same as the gain over the first five years ($22.5 billion). Over a longer time horizon, the loss of taxable withdrawals would dominate any gain from disallowing deductions, and the option's cumulative effect on revenues would be negative.

A rationale for this option is that it could boost private saving, for at least two reasons. First, it would accelerate increases in the limits on contributions to tax-favored accounts and maintain them at a higher level than the limits that apply under current law. Second, it would channel all contributions into back-loaded plans, which provide greater tax advantages—and hence more of an incentive to save—than do front-loaded plans that receive the same level of contributions (because taxes must still be paid out of a front-loaded plan's assets but not out of those of a back-loaded plan). In addition, the option would simplify people's decisions about saving by eliminating the need to choose among different types of savings plans.

Yet whether tax incentives truly increase private saving is uncertain, particularly among individuals who might save as much as $5,000 per year. Moreover, some observers believe that an immediate tax deduction is more likely to stimulate saving than the prospect of tax-free withdrawals in the future. A further advantage of retaining the current approach to IRAs is that people whose tax rate was likely to drop after they retired would be better off with a front-loaded plan. This option would deny them the opportunity to use one.

Eliminating the income thresholds that govern participation in back-loaded accounts and converting IRAs from front-loaded to back-loaded plans could have several benefits. One gain from such a policy is that it would lessen the complexity of the tax code, which in turn might reduce taxpayers' errors and also help allocate resources more efficiently (by improving people's understanding of the tax consequences of their decisions). A rationale for retaining the income thresholds, however, is their ability to limit the tax benefits realized by high-income people, who would probably save as much even without the incentive of such benefits.

Revenue Option 23

Consolidate Tax Credits and Tax Deductions for Education Expenses

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	*	-0.1	-0.1	*	**	-0.2	-3.9

Source: Joint Committee on Taxation.

Note: * = reduced revenues of less than $50 million; ** = added revenues of less than $50 million.

Over the past several years, the federal government's support of postsecondary education through the tax system has grown in magnitude and complexity. Today, taxpayers benefit from the following credits and deductions:

- The nonrefundable Hope credit, which provides a maximum benefit of $1,500 for qualifying tuition and fees. The credit is offered on a per-student basis and can be used by the taxpayer, the taxpayer's spouse, and dependents. (The student's expenses that are claimed under the credit must apply to the first two years of a postsecondary degree or certificate program, and the student must be enrolled at least half-time.)

- The nonrefundable Lifetime Learning credit, which has a maximum benefit of $2,000 for qualifying tuition and fees (that is, a subsidy rate of 20 percent for each dollar of qualifying expenses up to a maximum of $10,000). Each tax filer may take only one Lifetime Learning credit per year. Like the Hope credit, the Lifetime Learning credit applies to the taxpayer, the taxpayer's spouse, and dependents. But unlike the Hope credit, it can be used for postsecondary education beyond the first two years and not just by those who are attending school half-time or more.

- A deduction of $4,000 for qualifying postsecondary education expenses, which is available to taxpayers whose adjusted gross income (AGI) does not exceed certain thresholds ($65,000 for single filers and $130,000 for married couples filing jointly). A deduction of $2,000 is available for single filers whose AGI does not exceed $80,000 and joint filers whose AGI is less than $160,000. (The deduction is set to expire after 2005.)

- A maximum deduction of $2,500 for interest paid on student loans.

Qualification for those credits and deductions is limited by a number of factors in addition to those already noted. Each of the benefits phases out as a taxpayer's income rises above a certain point, but the beginning of the phaseout range for the credits is lower than that for the education deduction. A taxpayer cannot take both that deduction (up to $4,000) and a tax credit. People who claim the deduction for the most part are those who are not eligible for a credit because of the income phaseout (the deduction phases out at a higher level of income). However, the benefit that people receive from tax credits is generally (but not always) larger than that for the deduction.

This option, which is similar to one of the President's budgetary proposals for 2005, would combine the benefits provided for higher education into two tax credits.[1] Thus, it would amend the Hope and Lifetime Learning credits and eliminate the higher education and student loan interest deductions. However, it would include student loan interest of up to $2,500 as a qualifying tuition expense under the Lifetime Learning credit and allow that expense to be claimed by each student rather than by each tax filer. In addition, the option would raise the starting point of the phaseout range for both tax credits to $50,000 for single filers and $100,000 for joint filers. Once that point was reached, every dollar of the credit would be reduced by 5 percent of the difference between the taxpayer's modified AGI and the phaseout's starting point.[2] So for a single filer who qualified for a $2,000 Lifetime Learning credit, the credit would be fully phased out at an AGI of $90,000. After 2006, the phaseout

1. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals* (2004), pp. 93-94.

2. For most people, modified AGI is the same as AGI. Modified AGI begins with AGI as the base and then includes certain tax exclusions and deductions.

ranges would be indexed for inflation. The option would reduce revenues by $0.2 billion over the 2006-2010 period.

An advantage of this option is that it would simplify the tax preferences provided for higher education. On average, taxpayers would benefit more under the option than under current law, although some taxpayers would benefit less. Under current law, taxpayers receive a credit of 20 percent for qualifying education expenses. For taxpayers whose marginal rates were greater than 20 percent (the marginal rate is the rate of tax on the last dollar of income), substituting the Lifetime Learning credit for the education deduction or the deduction for interest on student loans, as this option would do, could result in lower benefits. For example, under current law, someone with a marginal tax rate of 25 percent who was paying $1,000 in student loan interest would receive a benefit of $250. Under this option, which would substitute the credit for the deduction, the benefit would be $200 (or $50 less).

RELATED PUBLICATION: *Private and Public Contributions to Financing College Education*, January 2004

Revenue Option 24

Integrate Corporate and Individual Income Taxes Using the Dividend Exclusion Method

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	-3.0	-3.4	-5.1	-16.9	-16.3	-44.7	-266.0

Source: Joint Committee on Taxation.

Income generated by the activities of corporations is taxed in varying ways, depending on the type of corporation and the form in which the income is paid out. Some of the income of corporations is taxed twice—first, as profits (under the corporate income tax) and second, as dividends and capital gains on corporate stock (under the individual income tax). At the same time, income in the form of interest on corporate bonds and the profits of Subchapter S corporations is not subject to the corporate tax but only to the individual income tax. Conversely, some corporate earnings are subject to taxation primarily under the corporate income tax but have little or no tax imposed under the individual income tax—because taxes on capital gains on stock can be deferred until the gains are realized (when the stock is sold). Because investors face different effective tax rates depending on the organizational form of the business in which they are investing, the corporate and individual income taxes are said to be nonintegrated.

That lack of integration reduces economic efficiency (the relationship between total resources used and the social benefits they generate) in a number of ways. It distorts the choice that business owners make between organizing and maintaining a business enterprise as either a C corporation (basically, a firm that is subject to the corporate tax) or an S corporation or noncorporate form, such as a partnership or proprietorship (neither of which faces the corporate tax). It also distorts the choice that corporations make between borrowing and issuing stock to finance investment (because interest, unlike dividends, is deducted from the corporation's income and thereby reduces its taxes). Further, it distorts the corporation's choice between paying dividends and reinvesting earnings (because reinvested earnings increase the value of the corporation's stock, the gain from which is taxed only when the stock is sold, if ever). Finally, the additional levy raises the overall taxation of income from capital, which distorts the choice that people make between saving and consuming. The costs to economic efficiency from those distortions are significant, with the loss in society's well-being estimated to equal about one-quarter to three-quarters of a percent of the value of households' consumption.

Policymakers could integrate the two income taxes in a variety of ways. They could subject all corporate earnings to the individual income tax (the way the earnings of an S corporation are treated); they could exclude stock dividends and capital gains from individual taxation; they could allow corporations to deduct dividends from their corporate taxable income; or they could subject all business income to a tax at the firm level and impose no tax on the income at the individual level. However, integration cannot be achieved simply by eliminating the corporate tax—that is, without any other changes to the tax system. Significant efficiency costs would persist because without the corporate tax, stockholders would defer (and in some cases avoid altogether) paying tax on corporate earnings that are not distributed as dividends.

As part of the President's 2004 budget, the Administration proposed to integrate the two income tax systems by changing the treatment of some dividends and capital gains. Under that proposal, individual taxpayers could exclude from their taxable income dividends and capital gains that had already been taxed as profits at the corporate level—provided those dividends and gains resulted from earnings that the corporation received after the proposal had been enacted into law. Instead of adopting the Administration's approach, policymakers in 2003 (in the Jobs and Growth Tax Relief Reconciliation Act, or JGTRRA) lowered the rate of tax on dividends and capital gains. Those lower rates expire at the end of 2008. (See Revenue Option 3 for the costs associated with extending those provisions.)

This option would permanently substitute the President's 2004 proposal for the rate reductions enacted in JGTRRA, thus returning to their pre-2003 levels the statutory tax rates on dividends and capital gains that have not been taxed at the corporate level. The option would reduce revenues by $3.0 billion in 2006 and $44.7 billion over the 2006-2010 period. The change would be permanent, whereas the current rates on dividends and capital gains that it would replace are temporary. (The cost of the option would be different if those rates were assumed to be permanent.)

The option's principal advantage is that it will more completely and consistently integrate the corporate and individual income taxes. The reduced tax rates on dividends and capital gains that currently apply still subject some corporate profits to additional taxation under the individual income tax. Moreover, the lower rate on gains that was enacted in JGTRRA applies to capital gains not only on corporate stock but also on other assets. The effect of that broad scope is to worsen other distortions in the tax code—a defect that would not arise under this option. Furthermore, because JGTRRA's rate reductions are scheduled to expire after 2008, much of the potential gain in efficiency that integration could bring by reallocating capital might not be realized under current law.

The main disadvantage of the option is its complexity. In order to limit the amount of forgone revenues, not all dividends and gains would be eligible for the exclusion—only those that resulted from earnings subsequent to the option's enactment into law. That limitation would require firms to maintain accounts and inform stockholders of the amounts of dividends and gains that they could exclude from their income—bookkeeping responsibilities that could turn out to be burdensome. In addition, the gains in efficiency that would result from this option would be less than those typically expected from integration because the option is not budget neutral. Finally, although the lower rates enacted in 2003 represented an incomplete integration of the two taxes, they substantially decreased the tax differentials that give rise to the distortions associated with the two levies' lack of integration. Hence, simply making the rates permanently lower would achieve many of the efficiency gains that full integration could bring but with much less complexity.

Revenue Option 25

Set the Corporate Tax Rate at 35 Percent for All Corporations

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+2.4	+4.9	+5.0	+5.0	+5.0	+22.3	+49.5

Source: Joint Committee on Taxation.

Under current law, so-called C corporations pay taxes on their income according to a progressive schedule of four statutory marginal tax rates: 15 percent, 25 percent, 34 percent, and 35 percent. (The marginal rate is the percentage of an extra dollar of taxable income that a corporation must pay in taxes.) This option would tax all corporate taxable income at the single statutory rate of 35 percent, raising $2.4 billion in revenues in 2006 and a total of $22.3 billion from 2006 through 2010.

The tax code's current structure applies different rates to different portions of a firm's income. Corporate taxable income below $50,000 is subject to the 15 percent rate; the system taxes income from $50,000 to $75,000 at 25 percent and income from $75,000 to $10 million at 34 percent. Taxable income in excess of $10 million is subject to the top rate of 35 percent. In addition to those explicit rates, corporate taxable income between $100,000 and $335,000 faces a further tax of 5 percent; an additional 3 percent tax is levied on income between $15 million and $18.3 million. Those additional taxes effectively phase out the benefit of the progressive structure for corporations with income above certain amounts. For example, a firm with taxable income of $18.3 million or more pays an average tax of 35 percent—despite the lower rates it pays on the first $10 million. Thus, this option would not affect the taxes that those firms pay.

Nor would it affect firms that operate as an S corporation or as a limited liability company (LLC). Owners of such enterprises pay tax on their total business income but at the rates of the individual income tax.

The government taxes the earnings of C corporations once at the corporate level and then again at the individual level if the firms distribute their earnings to shareholders. The progressive rate schedule for the corporate income tax was designed in part to lessen the effect of that "double taxation," thus encouraging entrepreneurship and providing some tax relief to businesses with small and moderate levels of profit. Of the approximately 1 million corporations that have positive corporate tax liabilities each year, all but a few thousand benefit from the schedule's reduced rates. (However, because those firms earn only about 20 percent of all corporate taxable income, the effect on revenues of the reduced rates is not that great.)

An argument supporting this option is that many of the corporations that benefit from the current rate structure are not small or medium-sized firms, which goes against the original rationale for the rates' progressivity. For example, under current law, large corporations can reduce their taxable income for certain years by sheltering some of it or by controlling when they earn income and incur expenses. The current system also allows individuals to shelter income by retaining earnings (rather than paying them out as dividends) in a small corporation. (That benefit does not apply to owners of personal services corporations, such as physicians, attorneys, and consultants, whose firms are taxed at a flat rate of 35 percent.)

Another argument against maintaining the current progressive rate structure for corporate taxation is that it favors firms that may have relatively low profits because they are inefficient. Except in the case of new or small firms, low profits may imply a small return on a firm's capital investment.

A disadvantage of this option is that it might have some repercussions on how firms raised capital. Replacing the current rate structure with the single rate of 35 percent would make debt financing more attractive than equity financing for firms that were benefiting from the lower rates.

Revenue Option 26

Repeal the "Lower of Cost or Market" Inventory Valuation Method

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+0.3	+0.7	+0.7	+0.7	+0.5	+2.9	+3.7

Source: Joint Committee on Taxation.

Firms that use the first-in, first-out approach to identifying inventory receive a tax advantage under current law because they can employ the "lower of cost or market" (LCM) method of inventory valuation. That method allows firms to deduct from their taxable income unrealized year-end losses on items in their inventory that have declined in value. (The losses are unrealized because the items have not actually been sold.) For items that have increased in value, firms may defer taxes on unrealized gains until the year in which the items are sold. Similarly, goods in a firm's inventory that cannot be sold at normal prices because of damage, imperfections, or similar problems qualify for the subnormal goods method of inventory valuation. That approach allows firms to immediately deduct the loss in value, even if in later years the firm may sell those goods and realize a profit on them.

This option would repeal, over a three-year period, the LCM and subnormal goods methods of inventory valuation and require all firms to value their inventories according to their cost. (Under the cost valuation method, firms generally must include in taxable income both the gains and losses from any changes in the value of their inventories when the goods are sold.) The option would increase revenues by $0.3 billion in 2006 and a total of $2.9 billion from 2006 through 2010.

Inventory valuation is an integral component of determining a firm's taxable profits, which, in accounting terms, are the difference between the firm's receipts and the cost of the goods it has sold. Most firms with inventories are required to use the accrual method of accounting. Under that approach, they calculate the cost of the goods they have sold by adding the value of their inventory at the beginning of the year to the cost of goods they purchased or produced during the year and then subtracting from that total the value of their inventory at the end of the year. In valuing their inventory, firms currently may use either the LCM method or the cost method; they can use the subnormal goods method regardless of which inventory valuation approach they choose.

The rationale for this option rests on the tax advantage that the LCM method provides. Under that approach to inventory valuation, the firm compares the market value of each item in its inventory with the item's cost and then uses the lower of the two amounts as the item's value. A firm's inventory will have a lower value under the LCM method than under the cost method if the market value of any item in the inventory is less than its cost. But the reverse is not true—because under the LCM method, inventory items that have appreciated in value over the year are pegged at their original cost. Using the resulting lower value for a firm's year-end inventory increases the portion of a firm's costs that are tax deductible in that year and thus lowers its taxable profits. By contrast, under the cost method of inventory valuation, gains and losses from changes in the value of a firm's inventory are included in taxable income only when the goods are sold.

For firms that experience both gains and losses from their inventories, the LCM method provides a tax advantage over the cost method of inventory valuation by treating gains and losses asymmetrically—firms can recognize losses without counting comparable gains. As a result, a firm may claim a deduction for certain losses in the value of its inventory even if, overall, the inventory's value has increased. The LCM method has two other features that may offer unwarranted advantages to the taxpayers that use it. First, once a firm has reduced the value of its inventory, current law does not require it to record an increase if market values subsequently rise. Second, market values under the LCM method are based on the replacement cost of inventory items, not on their resale value. Thus, the method allows a firm to reduce the value of items in its inventory if the items' replacement cost has declined—even though the firm may still be able to sell the inventory at a profit.

Firms that incur losses in the value of their inventory without gains to offset them would see a disadvantage in repealing the LCM method of inventory valuation. For those businesses, the method provides a "cushion" during economic downturns or in periods of uncertainty created by shifts in markets. A firm with inventories that have dropped in value has incurred an economic loss. If that loss was deferred (not accounted for) until the inventory was subsequently sold, analysts could argue that the taxpayer was overtaxed.

Revenue Option 27

Tax Large Credit Unions the Way Other Thrift Institutions Are Taxed

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.8	+1.3	+1.4	+1.5	+1.5	+6.5	+15.2

Source: Joint Committee on Taxation.

Credit unions are nonprofit institutions that provide their members with financial services—for example, they accept deposits and make loans. Originally, they were designed to be cooperatives whose members shared a common bond (in most cases, the same employer or the same occupation). Partly as a consequence of that distinction, federal income tax law treats credit unions more favorably than competing thrift institutions, such as savings and loans and mutual savings banks, by not taxing credit unions' retained earnings. (Retained earnings are the portion of net income that firms or institutions reserve rather than pay out in dividends.) This option would tax the retained earnings of large credit unions—those with more than $10 million in assets—similarly to the way that the retained earnings of other thrift institutions are taxed. However, it would permit small credit unions (less than $10 million in assets) to retain their tax-exempt status. The option would increase revenues by $0.8 billion in 2006 and a total of $6.5 billion from 2006 through 2010.

Initially, the retained earnings of credit unions, savings and loans, and mutual savings banks were all tax-exempt. In 1951, however, the Congress eliminated the exemptions for savings and loans and mutual savings banks on the grounds that those institutions are similar to profit-seeking corporations. Since that time, large credit unions have come to resemble other thrifts. Beginning in 1982, credit union regulators have allowed credit unions to extend their services (subject to some restrictions) to members of organizations other than the ones for which they were founded. In addition, most credit unions allow members and their families to participate even after a member has left the sponsoring organization.

That relaxation of restrictions has contributed to growth in the membership of credit unions, from about 5 million in 1950 to more than 80 million today. Large credit unions, like taxable thrifts, now serve the general public and provide many of the services offered by savings and loans and mutual savings banks. A significant number of credit unions offer mortgages and car loans, access to automatic tellers, credit cards, individual retirement accounts, and discount brokerage services. They also resemble thrift institutions in that they retain some earnings.

One argument for taxing those retained earnings of large credit unions comparably with the way earnings of other large thrift institutions are taxed is to improve efficiency. Taxing similar institutions in a similar manner promotes competition and induces them to provide services at the lowest cost. With their current tax advantage, credit unions can use their retained earnings to expand and thus displace the services of other thrift institutions—even though the latter may provide those services more efficiently.

Yet many credit unions are more like cooperatives than like their larger counterparts, which suggests that their retained earnings should be treated like those of other cooperatives. Like those institutions, most small credit unions have members with a single common bond or association. And in some cases, their organizations are rudimentary; volunteers from the membership may manage and staff the credit union, and the level of services may not be comparable with what other thrifts offer.

Allowing small credit unions to retain their tax exemption for retained earnings would affect about 3 percent of all assets in the credit union industry and about half of all credit unions. However, a difficulty encountered in taxing the assets of large credit unions but allowing the assets of small ones to remain tax-exempt is that the $10 million threshold for identifying a "large" credit union could be viewed as arbitrary.

Revenue Option 28

Repeal the Expensing of Exploration and Development Costs for Extractive Industries

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+3.6	+4.9	+4.0	+2.9	+1.7	+17.1	+19.3

Source: Joint Committee on Taxation.

Through various tax incentives, the current tax system treats extractive industries (producers of oil, gas, and minerals) more favorably than most other industries. One incentive designed to encourage firms to explore for and develop certain types of oil, gas, and hard minerals allows producers to "expense" some of their exploration and development costs (deduct them from their taxable income when they are incurred) rather than capitalize them (deduct them over time as the resulting income is generated). Replacing the expensing of those costs with the standard capitalization approach would increase revenues by $3.6 billion in 2006 and a total of $17.1 billion from 2006 through 2010. (The option incorporates the assumption that firms could still expense some of their costs, specifically those from unproductive wells and mines.)

Immediately deducting costs contrasts with the tax treatment that other industries face, wherein costs are deducted more slowly, according to prescribed rates of depreciation or depletion. The Tax Reform Act of 1986 established uniform capitalization rules that require certain direct and indirect costs related to property to be either deducted when the property is sold or recovered over several years as depreciation. (In both cases, the deduction of the costs from taxable income is postponed.) However, so-called intangible costs related to drilling and development (for example, the maintaining of a fund of working capital) and costs for mine development and exploration are exempt from those rules. Thus, the expensing of such costs provides an incentive for extractive industries that other industries do not have.

Costs for exploration and development that extractive firms can expense include costs for excavating mines, drilling wells, and prospecting for hard minerals—but not for oil and gas. Current law allows independent oil and gas producers and noncorporate mineral producers to fully expense their costs. However, for "integrated" oil and gas producers (companies involved in substantial retailing or refining activities) and corporate mineral producers, it limits expensing to 70 percent of costs. Firms subject to the 70 percent limit must deduct the remaining 30 percent of their costs over 60 months.

The rationale for expensing the costs of exploration and development has shifted from its original focus. When the incentive was put in place, its advocates argued that such costs were ordinary operating expenses. Today, those who would justify continuing the incentive emphasize the status of oil and gas as "strategic minerals" that are essential to national energy security. But expensing works in several ways to distort how society's resources are allocated. First, it causes resources to be used for drilling and mining that might be employed more productively elsewhere in the economy. Second, expensing may influence the way resources are allocated within the extractive industries. Firms may decide what to produce not on the basis of factors related to economic productivity but on the basis of the magnitude of the advantage that expensing provides—for example, the difference between the immediate deduction and the deduction over time, which reflects the true useful life of the capital. Such decisions may also rest on whether the producer must pay the alternative minimum tax—because in that case, expensing is limited. Third, expensing encourages producers to extract more resources now—which in the short run might make the United States less dependent on imported oil than it is at present but in the long run could mean that it would extract less and have to rely more on foreign producers.

RELATED CBO PUBLICATION: *Reforming the Federal Royalty Program for Oil and Gas*, November 2000

Revenue Option 29

Repeal the Tax Credit Against Motor Fuel Excise Taxes Now Given to Alcohol Fuels

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+1.4	+1.4	+1.5	+1.5	+1.5	+7.3	+7.6

Source: Joint Committee on Taxation.

Motor fuels are subject to excise taxes, but the tax code provides a credit against such taxes for fuels that are blends of gasoline and alcohol. This option would repeal that credit, increasing revenues by $1.4 billion in 2006 and $7.3 billion over the 2006-2010 period. Those estimates include reductions in income and payroll taxes that result from the higher amount of tax-deductible excise taxes.

The tax credit applies only to blends that use alcohol fuels produced from renewable sources—for example, ethanol, the primary fuel of that kind, which is made chiefly from corn. Producers of ethanol that is used as a fuel (its other uses, such as in cleaning products or solvent-based paints, are far less significant) are eligible for an excise tax credit of as much as 51 cents per gallon. The amount of the credit depends on the percentage of alcohol in the fuel. For instance, the credit for gasohol, which is 90 percent gasoline and 10 percent ethanol, is 5.1 cents per gallon. Policymakers first enacted a reduction in the taxation of ethanol-based fuels in the 1970s; as originally formulated, the law directly reduced the fuels' tax rate. The reduction was changed in 2004 to an equivalent tax credit, which is scheduled to expire at the end of calendar year 2010.

Proponents of eliminating the tax credit make several points. They argue that the costs to the government of increasing the use of ethanol outweigh the benefits and that the credit draws resources into the production of ethanol that might be better used elsewhere. They also contend that the credit amounts to an unnecessary transfer from taxpayers to the corporations that produce ethanol and, to some extent, to U.S. farmers (through higher prices for corn). Moreover, some proponents argue that subsidies are not needed when environmental regulations serve to increase demand.

Supporters of retaining the tax credit argue that it helps reduce demand for imported oil and provides environmental benefits by encouraging the use of renewable fuels that cause less air pollution when they are burned. Ethanol, however, currently displaces only about 1 percent of the United States' oil imports and therefore provides little protection from price shocks in the world's oil markets. Moreover, some proponents of eliminating the credit dispute the environmental benefits of using ethanol and argue that regulation is a better means of achieving environmental goals.

The benefits that advocates claim for ethanol come from its high oxygen content and its renewability. Oxygenated fuels, relative to fossil fuels, have the potential to add less carbon dioxide to the atmosphere, and indeed, the use of oxygenated gasoline during the winter as part of the Environmental Protection Agency's Oxy-Fuels program has reduced carbon monoxide emissions and helped improve air quality in some so-called carbon monoxide nonattainment areas. But whether the use of oxygenated fuels has improved overall air quality is unclear. Moreover, the production of ethanol currently requires substantial amounts of fossil fuels, and the fact that ethanol is a renewable fuel may be of little value to the environment. In sum, ethanol provides little more energy than must be used to create it and only a small reduction in carbon dioxide emissions at its current levels of use and efficiencies of production.

RELATED OPTIONS: 270-01, 270-03, and 270-05; Revenue Options 28 and 48

RELATED CBO PUBLICATIONS: *Fuel Economy Standards Versus a Gasoline Tax,* March 2004*; and Reducing Gasoline Consumption: Three Policy Options*, November 2002

Revenue Option 30

Tax the Income Earned by Public Electric Power Utilities

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+0.5	+0.7	+0.8	+0.8	+0.8	+3.6	8.1

Source: Joint Committee on Taxation.

The income that local governments earn from any public utility, including electric power facilities, is exempt from federal income tax. By contrast, the income of investor-owned utilities is taxable. Taxing the income of public facilities for generating, transmitting, and distributing electricity would increase revenues by $0.5 billion in 2006 and a total of $3.6 billion from 2006 through 2010.

In the past, local monopolies provided electricity, in part to take advantage of cost-saving economies of scale. Some of those utilities were public facilities, which had developed for a variety of reasons. For example, public facilities offered a feasible alternative in geographic areas where the low density of the population caused the cost of power per customer to be high and private producers were reluctant to enter a market in which the potential for profit appeared inadequate. Public utilities also developed in areas where citizens, worrying that a private provider might exploit its position as a monopoly, wanted to ensure that electricity would be available to all residential consumers at a reasonable cost. Now, however, states are in varying stages of deregulating electric power generation, in part because improved technologies have lessened the importance of economies of scale and in part because electric service is almost universal in this country, even in areas with few people.

The major argument for this option is its recognition that the changes that have occurred in the electricity market cast doubt on the benefits that society now receives from the public sector's involvement in providing electricity. The private sector already supplies approximately 75 percent of the nation's electric power. The competition that the industry's restructuring is bringing, say advocates of this option, will protect consumers from monopolistic pricing by private firms—although California's experience in 2000 and 2001 suggests that some degree of continued governmental oversight of the market will still be needed. Other beneficial outcomes of ending the favorable tax treatment of publicly owned electric power facilities might be a further boost to competition, the consumption of an economically efficient amount of public power, and the preservation of the corporate tax base.

One argument for continuing the exemption of public utilities' income has been that it keeps the price of power low and thus reduces the amount that lower-income people pay for electricity. But treating public facilities' income more favorably than that of other utilities is an inefficient way of accomplishing that objective. The federal government helps lower-income groups more directly with programs such as the Low Income Home Energy Assistance Program of grants to the states.

Taxing the income of public electric utilities might adversely affect consumers in some communities who rely on such facilities for their power. The tax would cause the price of publicly provided electricity to rise, and public utilities that found themselves uncompetitive might have to shut down some facilities that were inefficient. If those facilities were being financed with debt that had not yet been retired, state and local taxpayers could be left with significant costs. Further complicating a change such as the one described in this option are the numerous legal and practical issues that would have to be resolved if the federal government taxed income earned from what might be termed business enterprises of state and local governments.

RELATED OPTIONS: Revenue Options 27 and 33

RELATED CBO PUBLICATION: *Causes and Lessons of the California Electricity Crisis*, September 2001

Revenue Option 31

Repeal Tax-Free Conversions of Large C Corporations to S Corporations

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	*	*	*	*	+0.1	+0.1	+1.8

Source: Joint Committee on Taxation.

Note: * = added revenues of less than $50 million.

For tax purposes, the predominant forms of business enterprise are C corporations, S corporations, partnerships, and sole proprietorships. Each structure has different implications for the tax liability of the entity and its owners and for the owners' legal liability. Businesses whose stock trades publicly are usually C corporations, although many small, privately owned businesses are also structured in that way. The income of a C corporation faces a two-tiered tax. The firm incurs a tax liability at the corporate level on its net income and capital gains. When it distributes its after-tax profits in the form of dividends to shareholders, a second tax liability—this time for shareholders—is incurred on those dividends. The owners of C corporations are not legally liable for the actions of the corporation.

Businesses such as partnerships, sole proprietorships, and S corporations are set up in a so-called flow-through structure. Income and expenses pass through the business to the shareholders (in the case of an S corporation) or to the partners or proprietors (in the case of partnerships and sole proprietorships), and the income is generally free from corporate income taxes. But shareholders, partners, and proprietors pay tax—at their own income tax rates—on all income that their businesses generate, even if that income is reinvested in the firm.

One difference between S corporations and the other two kinds of flow-through firms is legal liability. Owners of S corporations—unlike sole proprietors or partners in limited or general partnerships—have limited liability. Yet they face many restrictions: for example, S corporations may have no more than 100 owners, and they may not have C corporations as shareholders.

Until recently, S corporations were the only vehicle that offered owners both limited liability and a form of tax treatment that placed the income and losses from their businesses under the personal income tax. In 1988, the Internal Revenue Service ruled that limited liability companies (LLCs), which are defined under state law, could be treated as partnerships for federal tax purposes (though with some restrictions). Over time, the distinction between S corporations and partnerships has blurred.

Because the income of C corporations faces a two-tiered corporate tax and the income of S corporations and partnerships is taxed only once, under current law, a C corporation may reduce the tax liability on some of its income by electing to be treated as an S corporation or by converting to a partnership. But the tax code provides an incentive to choose the S corporation structure. Converting to an S corporation is tax-free in many circumstances. By contrast, converting to a partnership is taxable; it requires the corporation to "recognize" (include in its taxable income) any built-in gain on its assets and requires the shareholders to recognize any such gain in their corporate stock. Under section 1374 of the Internal Revenue Code, if a C corporation converts to an S corporation, the appreciation of the firm's assets while it was a C corporation is not subject to corporate income tax—unless the assets are sold within 10 years of the conversion. Thus, current law allows a C corporation to avoid the two-tiered corporate tax by converting tax-free to an S corporation.

This option would repeal tax-free conversions for C corporations whose value was greater than $5 million at the time of the conversion. That is, when a C corporation with a value of more than $5 million converted to an S corporation, the corporation and its shareholders would immediately recognize the gain in their appreciated assets. Taxing such conversions would increase income tax revenues by less than $50 million in 2006 and $0.1 billion over the 2006-2010 period.

A major advantage of this option is that repealing tax-free conversions by C corporations would treat economically similar conversions—from two-tiered corporate tax systems to single-tiered systems—in the same way. That equalization would, in turn, allow society's resources to be more efficiently allocated by making tax considerations less important in decisions about the legal form that a firm might take. However, people who think that S corporations resemble corporations more closely than they do partnerships may consider it beneficial to preserve the current differential tax treatment. According to that viewpoint, current law merely allows a C corporation (providing it meets the legal requirements) to choose a different corporate form—that of an S corporation—and change its filing status without having to pay tax.

Revenue Option 32

Apply the Limited Depreciation Schedule to All Business-Use Sport Utility Vehicles and Automobiles

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.1	+0.1	+0.2	+0.2	+0.1	+0.7	+1.1

Source: Joint Committee on Taxation.

Taxpayers are generally allowed to recover the cost of depreciable business property under the tax code's modified accelerated cost-recovery system (MACRS). They may also, under certain circumstances, expense rather than depreciate the first $100,000 of the cost of depreciable property—that is, deduct it from taxable income in the year in which the property is placed in service rather than in scheduled increments over time. (After 2007, however, the amount that can be expensed in that way will be reduced to $25,000.)

The tax code provides a different treatment for recovering the costs of vehicles with a loaded gross vehicle weight (GVW) of less than 6,000 pounds. Deductions for depreciation of such vehicles are generally subject to a schedule of limits: as of tax year 2001, $3,060 in the first tax year, $4,900 in the second, $2,950 in the third, and $1,775 in each additional year. (Those amounts are indexed for inflation as measured by the consumer price index for automobiles.) Because of those limits, the cost of acquiring an automobile for business use does not typically qualify for the full tax-favored treatment of depreciation and expensing.

The limits on depreciation, however, do not apply to vehicles with a loaded GVW of more than 6,000 pounds—a category that includes most sport utility vehicles (SUVs) and light trucks. As a result, the cost of those vehicles can be written off at a much faster rate than the cost of lighter vehicles. The American Jobs Creation Act of 2004, however, limited to no more than $25,000 the amount that a firm can expense for any SUV or light truck weighing less than 14,000 pounds that meets certain minor criteria—an amount substantially smaller than the $100,000 limit that applies to other property. Yet even with that limitation, the tax advantages of buying such a vehicle are sizable compared with the purchase of lighter passenger vehicles, since firms cannot expense the cost of those vehicles and can only claim annual depreciation up to the limits described earlier. For example, the buyer of a $45,000 SUV weighing between 6,000 pounds and 14,000 pounds and used entirely for business purposes may expense $25,000 in the first year and deduct an additional $20,000 on the basis of the five-year MACRS schedule. (The schedule would allow a deduction of an additional $4,000 in the first tax year, $6,400 in the second, $3,840 in the third, $2,300 in the fourth and fifth, and the remaining $1,160 in the sixth.) With that differential treatment, the tax code provides an incentive for business car buyers to purchase SUVs or similarly heavy vehicles (that is, with a loaded GVW of more than 6,000 pounds) when they might otherwise have purchased smaller automobiles.

This option would apply the limited depreciation schedule to all business-use SUVs and automobiles regardless of weight but would not change the tax treatment of other types of vehicles with a loaded GVW of more than 6,000 pounds. The option would increase revenues by $0.1 billion in 2006 and $0.7 billion over the 2006-2010 period.

The option would have several advantages. It would increase economic efficiency (the relationship between total resources used and the social benefits they generate) by eliminating the tax incentive for businesses and self-employed individuals to purchase SUVs instead of smaller vehicles. Moreover, because heavy SUVs tend to emit more pollutants and have lower gas mileage than lighter vehicles, this option would also reduce pollution and the consumption of fossil fuels.

A disadvantage of the option would be its denial of the tax-favored treatment of expensing to firms that legitimately require SUVs to conduct their business. Ideally, the option would allow expensing only of those legitimate business purchases, but the law cannot be targeted that precisely. Another argument against the option is that it will not eliminate the incentive for businesses and self-employed individuals to purchase other vehicles with loaded GVWs exceeding 6,000 pounds—even though a smaller vehicle that produced less pollution might be an acceptable alternative in those cases as well.

RELATED OPTIONS: Revenue Options 50, 51, and 53

Revenue Option 33

Eliminate Private-Activity Tax-Exempt Bonds

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+0.2	+0.6	+1.1	+1.7	+2.2	+5.8	+23.9

Source: Joint Committee on Taxation.

Tax law permits state and local governments to issue bonds whose interest income is exempt from federal taxation—which allows those bonds to bear lower rates of interest than taxable bonds bear. (The bondholder is compensated for the lower interest rate by not paying federal tax on the interest income.) For the most part, the bonds' proceeds finance public projects, such as schools, highways, and water and sewer systems. But state and local governments also issue tax-exempt securities known as private-activity bonds, whose proceeds are used by nongovernmental entities to finance quasi-public facilities and private-sector projects that include mortgages for rental housing and single-family homes; facilities such as airports, docks, wharves, mass transit, and solid waste disposal plants; small manufacturing facilities and agricultural land and property for first-time farmers; student loans; and facilities for nonprofit institutions, such as hospitals and universities. This option would eliminate the tax exemption for all new issues of private-activity bonds, increasing revenues by about $5.8 billion over the 2006-2010 period.

The Congress has restricted tax-exempt financing for private purposes on several occasions, beginning in 1968. In the Tax Reform Act of 1986, legislators made the interest earned on newly issued private-activity bonds taxable by including it in the base for the alternative minimum tax. In addition, they limited the volume of new bonds for exempt facilities, small manufacturing facilities, student loans, and housing and redevelopment that could be issued by all governmental units within a state. That cap on the volume of all new bond issues within a state has been raised over time; in 2002, it was indexed for inflation. (At that time, the annual volume that the law allowed was the greater of $75 per resident or $225 million.) Bonds for some private activities are exempt from the limits; they include bonds for airports, ports, and solid waste disposal facilities that meet requirements for government ownership, as well as certain bonds for nonprofit 501(c)(3) organizations (primarily hospitals and educational institutions).

Eliminating the tax exemption for new private-activity bonds would force the projects that would otherwise be financed with such bonds to compete for funding at the rate prevailing in private markets. Altering the projects' financing in that way would redirect savings to more valuable uses and allocate resources more efficiently. Although some private-purpose bonds may subsidize activities that merit federal support, tax-exempt financing is not the most efficient way to provide such help. The reduction in federal revenues that occurs with such financing exceeds the drop in the borrower's interest costs. If, instead, the government provided a direct subsidy, it could eliminate the additional loss of revenue. Other drawbacks to tax-exempt financing are that access to the subsidy such financing provides is open-ended and, unlike explicit appropriations, it does not receive automatic scrutiny by policymakers in the annual budget process.

Rather than eliminating the tax exemption for private-activity bonds, policymakers could reduce their volume. An alternative option would return the cap on bond issues to its former level of $50 per resident or $150 million and would end indexing of the cap. That approach would allow the real (inflation-adjusted) value of private-activity bonds to decline slowly as the price increased. Over the 2006-2010 period, this option would increase revenues by about $0.6 billion.

RELATED CBO PUBLICATION: *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures*, July 2004

Revenue Option 34

Repeal the Low-Income Housing Credit

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+0.5	+0.8	+0.8	+0.9	+0.9	+3.9	+8.9

Source: Joint Committee on Taxation.

The low-income housing credit (LIHC) subsidizes the construction, substantial rehabilitation, or purchase of buildings that are used to provide low-income rental housing. Qualifying individuals and corporations receive tax credits over a 10-year period that can be worth as much as 70 percent of a building's construction or rehabilitation costs or 30 percent of its purchase price. The majority of qualifying projects thus far have been new construction.

To qualify for the LIHC, the owners of a project must fulfill several requirements. They must set aside a certain number of units for low-income renters—specifically, at least 20 percent of a building's rental units for families whose income is below 50 percent of the median income in the area or 40 percent of its units for families whose income is below 60 percent of the median. In addition, rents are restricted. The set-aside requirements and the restrictions on rents apply for at least 15 years. Yet unlike most tax provisions, the LIHC is not necessarily available once those requirements have been met. The credit is limited (by statute) and allocated by state housing authorities.

This option would repeal the tax credit for new projects (the credit would continue to be provided for previously approved projects that still had time to run on their 10-year periods). It would increase revenues by $0.5 billion in 2006 and $3.9 billion from 2006 through 2010.

An argument for eliminating the LIHC is that in most places, housing vouchers could assist the same number of people at a lower cost. Low-income tenants can use such vouchers to pay for all or part of the rent for the housing of their choice as long as the dwelling meets minimum standards for habitability. In most instances, housing vouchers are more likely than tax credits to have the desired effect because the existing stock of buildings can usually provide adequate housing more affordably than either new construction or buildings that have been substantially rehabilitated. Extra overhead costs (such as those for additional paperwork and approvals) also make some housing that is subsidized by the LIHC more expensive to produce and rent.

Another reason for repealing the credit is that it does not by itself always fulfill the purpose that it was designed to serve. In general, households with the lowest income do not rent units whose construction or rehabilitation has been supported by the LIHC unless the households or the project receive additional subsidies. Rather, the credit tends to benefit lower-middle-income people whose income typically is too high to allow them to qualify for voucher and public housing programs.

An argument for retaining the credit is that in some neighborhoods, existing housing that meets minimum standards for habitability at affordable rents is scarce. Furthermore, the money spent to build new housing and rehabilitate existing dwellings may help revitalize neighborhoods. In contrast, similar expenditures on housing vouchers are unlikely to have a noticeable impact—because the vouchers' impact is more likely to be diluted among a number of neighborhoods.

Revenue Option 35

Permanently Extend 50 Percent Partial Expensing Under JGTRRA and Increased Limits Under Section 179 of the Internal Revenue Code

						Total	
(Billions of dollars)	2006[a]	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	-103.4	-59.0	-52.5	-45.1	-36.6	-296.6	-427.1

Source: Joint Committee on Taxation.

a. Includes $38.7 billion that would result from retroactive application of the option to January 1, 2005. Thus, the 2006 estimate incorporates the assumption that the option will be enacted too late to affect receipts in 2005.

The tax code allows corporations to deduct from their income the yearly loss in value they incur over time in their equipment and property. That depreciation, which is usually calculated as a percentage of the purchase price, is deducted over the life of the investment. However, for some qualifying property (generally equipment but not structures), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) allows firms to deduct an additional amount for depreciation—50 percent of the investment's adjusted basis (generally, the investment's original cost)—in the first year after its purchase. (That type of deduction is known as partial expensing.) The provision in JGTRRA applies primarily to investment in equipment: for the most part, the additional depreciation can be taken only if the property's recovery period (over which the firm depreciates the equipment and so recovers its investment) is 20 years or less, and the recovery period for structures is usually much longer. (The law makes some exceptions—specifically, for investments by water utilities, qualifying property improved by a leaseholder, and some computer software.) The JGTRRA provision replaced one in the Job Creation and Worker Assistance Act of 2002 (JCWAA), which offered an additional depreciation deduction of 30 percent on some investments in the first year after they were purchased. However, the 50 percent deduction under JGTRRA expired at the beginning of 2005. Generally, property acquired on or after January 1, 2005, is not eligible for those benefits.

Recent legislation has also provided a tax advantage to encourage investment by smaller firms. (Those laws affect provisions in section 179 of the Internal Revenue Code, which covers expensing of equipment by small businesses.) JGTRRA and the American Jobs Creation Act of 2004 (AJCA) allow the owners of some businesses to immediately deduct ("expense") an additional amount of the cost of the property they place in service before 2008. Owners can now expense the first $100,000 of such costs under section 179—which constitutes an increase of $75,000 compared with prior law. JGTRRA and AJCA also increased the threshold for phasing out that benefit, boosting it to $400,000 in investment costs (the previous threshold was $200,000). Those laws index both the expensing and the phaseout amounts to inflation for years after 2003. The President's budget for 2006 proposes to permanently extend the additional expensing and the higher thresholds.

This option would permanently extend both JGTRRA's provision for 50 percent partial expensing for all firms and the increased section 179 expensing for small businesses. It would reduce revenues by $103.4 billion in 2006 and $296.6 billion over the 2006-2010 period.

One advantage of this option, which lowers the tax burden on income from capital, is its capacity to spur businesses to invest in equipment. That investment could in turn lead to greater innovation and economic growth. But the option would also exacerbate certain economic distortions that existed before JGTRRA or JCWAA were enacted. The combination of depreciation rates and asset lifetimes made the top effective tax rates on firms' investment in equipment lower than the rates on investment in structures. That disparity encouraged firms to invest more in equipment and less in structures than they might have without the tax incentive. The partial expensing provisions increase that distortion and so keep society's resources from being allocated to their most productive uses.

RELATED OPTION: Revenue Option 36

Revenue Option 36

Extend the Period for Recovering the Cost of Equipment Purchases

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+2.8	+8.6	+12.5	+13.7	+15.0	+52.6	+98.3

Source: Joint Committee on Taxation.

When a firm calculates its taxable income, tax law allows it to deduct many of the expenses that it incurs to produce the goods and services it sells. One of the expenses that firms deduct from their income is depreciation—the drop that occurs in the value of its productive assets over time. To calculate taxable income accurately, deductions for depreciation should reflect an asset's actual economic decline—that is, economic depreciation, which takes inflation over the lifetime of the asset into account. However, rates of depreciation are established in the tax code, and depreciation deductions are not indexed for inflation. As a result, the real (inflation-adjusted) value of the depreciation allowed by tax law depends on the rate of inflation.

The Tax Reform Act of 1986 is the major source of the current rates of depreciation for tax purposes, which were set to approximate economic depreciation with inflation of 5 percent. Yet in the Congressional Budget Office's estimation, the inflation applicable to economic depreciation during the coming decade will be just above 2 percent. That estimated decline of 3 percent means that tax depreciation is accelerated relative to economic depreciation—which results in the understatement of firms' taxable income. All other things being equal, depreciation deductions for equipment contribute more to that understatement than do deductions for structures because the service lives of equipment (the time over which depreciation deductions can be taken) are shorter than the service lives of structures and as a result, changes in inflation affect depreciation deductions for equipment more strongly than they affect deductions for structures. In addition, policymakers since 1986 have extended the useful lifetimes of some kinds of structures for calculating depreciation.

The incentive that the tax code provides—the greater effect on a firm's taxable income (and eventually on its effective tax rate) of depreciation for equipment than for structures—encourages firms to invest in equipment instead of allowing economic returns to guide their investment spending. To equalize the effective tax rates on different types of investment and lessen the tax code's dampening effect on investment in structures, this option would lengthen the lifetime of equipment for tax purposes. Property that currently had a lifetime of three, five, seven, 10, 15, or 20 years would instead shift, for tax purposes, to a lifetime of four, eight, 11, 20, 30, or 39 years, respectively. Under the assumptions that inflation would be just over 2 percent and a 5 percent discount rate would be used (to adjust for the change in the worth of a dollar over time), the effective tax rate on equipment, for all firms on average, would be about 35 percent, and the rate on structures would be 34.7 percent—which is very close to the top corporate statutory income tax rate of 35 percent. The option would increase revenues by $2.8 billion in 2006 and $52.6 billion over the 2006-2010 period.

Those average tax rates are quite sensitive to inflation. If inflation was lower by half a percentage point, the rates would be 33.7 percent for equipment and about 34 percent for structures. Conversely, if inflation was higher by half a percentage point, the rates for equipment and structures would be 36.5 percent and 35.3 percent, respectively. If, therefore, inflation differed from expectations, new distortions would emerge over the long run between investment in equipment and structures.

One advantage of this option is that it would bring the effective tax rate on investment in equipment close to the effective rate on structures. That relative parity would lessen the distortion (in the form of a tax incentive) that now affects firms' choices between investing in equipment and investing in structures, thereby increasing economic efficiency.

However, the option would also discourage firms from investing in equipment relative to the incentive that the tax code recently provided by increasing the tax burden on income flowing from a business's investment in capital in the form of equipment. Both the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, to stimulate the economy, gave firms temporary tax advantages for investing in equipment. The option would thus be inconsistent with recent legislation that lowered the after-tax cost of such investment.

RELATED OPTION: Revenue Option 35

Revenue Option 37

Expand the Medicare Payroll Tax to Include All State and Local Government Employees

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+0.7	+0.9	+0.8	+0.7	+0.7	+3.8	+5.5

Source: Joint Committee on Taxation.

Certain groups of employees of state and local governments do not pay the Medicare payroll tax, which under current law is 2.9 percent of earnings. (Half of the tax is paid by the employee and half by the employer.) Almost all private-sector workers pay the tax, and employees of the federal government have paid it since 1983, as required by the Tax Equity and Fiscal Responsibility Act of 1982. The Consolidated Omnibus Budget Reconciliation Act of 1985 mandated that state and local employees who began work after March 31, 1986, pay the Medicare payroll tax, but it did not make the tax mandatory for people hired before that date. Under the Omnibus Budget Reconciliation Act of 1990, the tax's reach was broadened to include all state and local government employees who were not covered by a retirement plan through their current employer.

This option would impose the Medicare tax on all state and local government employees who do not now pay it and increase revenues by $0.7 billion in 2006 and a total of $3.8 billion from 2006 through 2010. The annual gain in receipts under the option would gradually decline as employees who were hired before April 1986 left the payrolls of state and local governments. Although this option could result in significant outlays over the long run (because of the increase in the number of Medicare beneficiaries), its short-run costs would be relatively small, because few people would qualify for Medicare benefits in the near term solely as a result of this tax change. (To collect Medicare benefits, workers must generally pay the tax for 10 years and reach age 65—or become disabled. They could also qualify as the spouse of an insured worker.)

Requiring all state and local government employees to pay Medicare payroll taxes could be justified on the grounds of fairness. Only one in 10 employees of state and local governments do not currently pay the Medicare tax through their employers; nevertheless, most of those workers will receive Medicare benefits under current law because they either had other, covered jobs in the past or will receive coverage through their spouse's employment. Thus, the broader coverage that this option would institute would lessen the inequity of those employees' receiving high levels of benefits in relation to the payroll taxes they had paid. Of course, expanding Medicare's coverage to include all state and local government employees would increase the federal government's obligation for future benefits under the program and could affect the finances of some state and local governments with large numbers of workers who were not currently covered by Medicare.

Revenue Option 38

Calculate Taxable Wages in the Same Way for Both Self-Employed People and Employees

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues							
On-budget	+0.2	+0.3	+0.3	+0.3	+0.3	+1.4	+3.0
Off-budget	+0.1	+0.1	+0.1	+0.1	+0.1	+0.5	+1.4

Source: Joint Committee on Taxation.

Social Security and Medicare levies come in two forms: the Federal Insurance Contribution Act (FICA) tax paid on wages and the Self-Employment Contribution Act (SECA) tax paid on income from self-employment. Under FICA, employees and employers each pay a Social Security tax of 6.2 percent on wages up to a taxable maximum ($90,000 in 2005) and a Medicare tax of 1.45 percent on all wages. Until 1983, the tax rate levied on income from self-employment (the SECA rate) was lower than the combined employer and employee rate under FICA. As part of the Social Security Amendments of 1983, the Congress increased the effective tax rates under SECA starting in 1984. The report of the conference committee said that the law was "designed to achieve parity between employees and the self-employed" beginning in 1990.

In fact, the current method for calculating SECA taxes allows a self-employed taxpayer to pay less tax than a worker with the same nominal income who is not self-employed. Under current law, self-employed people calculate their tax on an income base that comprises their total compensation less 7.65 percent; for other workers, the tax is calculated on total compensation without a percentage deduction. For example, an employee who earns $50,000 pays $3,825 in FICA taxes, which are calculated on a taxable base of $50,000, and his or her employer also pays $3,825 in FICA taxes. Because the employer's contribution amounts to additional compensation, the employee is implicitly earning $53,825 and paying $7,650 in employment taxes. An otherwise identical worker who is self-employed and earning the same $53,825 pays SECA taxes equal to only $7,605, or $95 less ($53,825 less 7.65 percent times the SECA rate). The difference arises because comparability requires that the 7.65 percent adjustment be applied to a base of $50,000, not $53,825.

The current-law method of calculating the taxable base for self-employed workers creates a second disparity for workers who earn more than Social Security's taxable maximum. Among people with earnings above the maximum, workers who are self-employed pay the same amount of Social Security tax that employees pay—the tax on $90,000—but they pay less Medicare tax. For example, an employee who earns $100,000 and his or her employer each pay the maximum amount of Social Security taxes ($5,580) as well as $1,450 in Medicare taxes. The employee's total compensation is thus $107,030, and the total FICA tax is $14,060. The taxable base for that person's self-employed sibling who earns $107,030 is $98,842.21 (total compensation of $107,030 minus 7.65 percent). The self-employed sibling pays the same maximum Social Security tax but only $2,866.43 in Medicare taxes—or $33.57 less.

Indeed, high-income self-employed taxpayers may pay as much as 6.3 percent less in Medicare taxes under SECA than employees with similar total compensation pay under FICA. That difference has existed since 1991, when the Congress first set a taxable maximum for Medicare that was higher than the taxable maximum for Social Security. This option would eliminate the difference between the way wages subject to the payroll tax are calculated for self-employed people and the way they are determined for employees. Changing the calculation of SECA taxes would increase on-budget revenues by $1.4 billion from 2006 to 2010. (That estimate includes reductions in income taxes because a portion of the additional SECA taxes are tax deductible.) Off-budget SECA receipts, which are credited to the Social Security trust funds, would increase by $0.5 billion over that period. The option would require a slight change in Schedule SE (the income tax form for reporting self-employment income).

This option would help make the tax system more equitable by ensuring that individuals who received the same compensation paid the same amount of payroll tax. One drawback to the option, however, would be the complexity it would introduce into the structuring of the FICA tax. The Social Security tax would need different taxable maximums for workers and self-employed people, and different methods of calculation would have to be used to determine the taxes for the two groups.

Revenue Option 39

Increase the Upper Limit for Earnings Subject to the Social Security Payroll Tax

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues							
Tax 92 percent of earnings	+19.6	+51.3	+54.0	+57.2	+60.5	+242.6	+581.1
Tax 91 percent of earnings	+17.5	+45.8	+48.1	+50.9	+53.7	+216.0	+515.6
Tax 90 percent of earnings	+14.8	+38.8	+40.6	+42.9	+45.2	+182.3	+433.4

Source: Joint Committee on Taxation.

Social Security—which is composed of the Old-Age, Survivors, and Disability Insurance (OASDI) programs—is financed by a payroll tax on employees, employers, and self-employed people. Only earnings up to a specified maximum are taxed, although that amount automatically increases each year. (In 2005, the maximum amount of earnings taxed under Social Security is $90,000.) This option would increase the earnings subject to the payroll tax under three scenarios: tax 92 percent, 91 percent, or 90 percent of earnings (with maximum amounts subject to tax of $190,000, $170,000, or $150,000, respectively). After the boost in the percentage of earnings covered, the maximum limit would be indexed thereafter, as it is under the present system; also, the percentage of covered wages, as under the current system, would then decline. Under the first scenario of 92 percent coverage, the option would generate $19.6 billion in receipts in 2006 and a total of about $242.6 billion from 2006 through 2010; under the second scenario of 91 percent coverage, $17.5 billion in receipts in 2006 and a total of about $216 billion from 2006 through 2010; and under the third scenario of 90 percent coverage, $14.8 billion in receipts in 2006 and a total of about $182.3 billion from 2006 through 2010. However, some of those revenues would be offset by the additional retirement benefits that Social Security would pay to people with income above the current law's maximum taxable amount. All of those revenue estimates include effects on individual income taxes that result from assumed changes in the taxable and nontaxable components of labor compensation.

When Social Security began in 1937, about 92 percent of the earnings from jobs covered by the program were below the maximum taxable amount. That percentage gradually declined over time because the maximum was raised only occasionally, when the Congress enacted specific increases to it. In the 1977 amendments to the Social Security Act, the Congress boosted the percentage of covered earnings subject to the tax to 90 percent by 1982; it also provided for automatic increases in the ceiling each year thereafter to equal the growth in average wages. Despite that indexing, the fraction of earnings that is taxable has slipped over the past decade as a result of faster-than-average growth in the earnings of the highest-paid workers. In 2003, the portion of earnings from employment covered by OASDI that fell below the maximum was approximately 86 percent.

Subjecting a larger percentage of earnings to the payroll tax would lessen the tax's regressivity. Because people who have income above the ceiling do not pay the tax on all of their earnings, they pay a lower share of their total income in payroll taxes than do people whose total earnings fall below the maximum. Making more earnings taxable would raise payroll taxes for high-income earners—and move the tax toward proportionality. Although that change could also lead to higher Social Security payments for people with earnings above the prior maximum, the additional benefits would be small relative to the additional taxes those earners would have to pay.

A drawback of this option is that raising the earnings cap could weaken the link between the taxes that workers pay into the system and the benefits that they receive, an important aspect of the Social Security system since its inception. Additionally, this option would reduce the rewards of working for people whose earnings are above the maximum now, because those earnings would become subject to the payroll tax. As a result, such workers would have an incentive to work less or to take more compensation in the form of fringe benefits that would not be subject to payroll taxes.

RELATED CBO PUBLICATIONS: *The Outlook for Social Security,* June 2004; *The Long-Term Budget Outlook,* December 2003; and *Social Security: A Primer*, September 2001

Revenue Option 40

Increase Federal Employees' Contributions to Pension Plans

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.3	+0.6	+0.8	+0.9	+0.9	+3.4	+8.3

Source: Congressional Budget Office.

Most government workers covered by the Civil Service Retirement System (CSRS), the older of the two major federal civilian retirement plans, are required to contribute 7 percent of their salary to their retirement fund for a defined-benefit pension (one in which the level of benefits is set by formula and is not affected by the amount an employee contributes). CSRS workers pay no Social Security taxes, however. Employees covered by the other major civilian plan, the Federal Employees Retirement System (FERS), must generally contribute at least 0.8 percent of their pay toward a defined-benefit plan and pay 6.2 percent in Social Security taxes.

This option would increase the contributions that most federal civilian workers would have to make to their defined-benefit retirement plan. Those contributions would increase by 0.25 percentage points (relative to current levels) in calendar year 2006, 0.4 percentage points in calendar year 2007, and 0.5 percentage points starting in calendar year 2008. (Those increases would match the ones that the Balanced Budget Act of 1997 temporarily imposed through 2002.) Adopting those changes for civilian employees would boost revenues by $0.3 billion in 2006 and $3.4 billion through 2010 (assuming that agencies' contributions for employees remained the same, as was the case under the Balanced Budget Act).

The main rationale for requiring federal workers to pay more for their retirement plans is that it would make the government's costs for civilian pension benefits more like those of private-sector employers but would still maintain a high level of salary replacement once people retired. Compared with some options (such as option 600-03) that would cut the benefits paid to current retirees, requiring employees to make larger contributions would have the advantage of giving workers more time to adjust to the change in compensation. Most employees' take-home pay would not decline if the higher contributions were offset by the across-the-board wage increases that federal workers usually receive in January. (Employees could also maintain their take-home pay by reducing their contributions to the federal Thrift Savings Plan, which is similar to a 401(k) plan.)

One argument against the changes in this option is that they would be roughly equivalent to a 0.5 percent pay cut for most federal civilian employees and would diminish the government's compensation package relative to that of the private sector. (Private firms seldom require employees to contribute to defined-benefit pension plans.) Those factors would weaken the government's ability to attract new personnel and might force federal agencies to either increase cash compensation for their employees or settle for having a less skilled workforce.

RELATED OPTIONS: 600-02, 600-03, and 600-04

RELATED CBO PUBLICATIONS: *Measuring Differences Between Federal and Private Pay*, November 2002; *The President's Proposal to Accrue Retirement Costs for Federal Employees*, June 2002; *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998; and *Comparing Federal Salaries with Those in the Private Sector*, July 1997

Revenue Option 41

Extend or Freeze the Estate and Gift Tax Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues							
Option 1	0	+6.7	+7.7	+8.4	+18.0	+40.8	-7.0
Option 2	-8.8	-5.1	-4.9	-5.1	+2.9	-21.0	-123.0
Option 3	-31.8	-30.2	-31.7	-33.4	-27.0	-154.1	-415.3
Option 4	-1.1	-1.5	-1.9	-1.7	-2.4	-8.6	-270.7

Source: Joint Committee on Taxation.

When a person dies, an estate tax is imposed on the value of the assets that are transferred at death, and a gift tax is paid on the value of taxable gifts made during the decedent's lifetime. Only the portion of the estate that exceeds an exempt amount ($1.5 million in 2005 and increasing thereafter until 2011) is subject to the estate tax. Likewise, only taxable gifts that exceed the lifetime exemption ($1 million in 2002 and thereafter) are subject to the gift tax. Gifts and bequests between spouses and charitable bequests are exempt from taxation.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phases out and ultimately repeals estate taxes. (It does the same for generation-skipping transfer taxes, which are designed to prevent estates from escaping some estate taxation by transferring assets—as gifts during the decedent's life or as bequests—to individuals more than one generation younger than the transferor.) In addition, EGTRRA retains but reduces the gift tax.

The phasing out of the taxes primarily takes the form of increases in the amount of the estate that is exempt from taxation and reductions in the estate and gift taxes' top marginal rates. EGTRRA sets the amount of the exemption under the estate tax at $1.5 million for 2005, with scheduled increases to $2 million in 2006 and $3.5 million in 2009. The law also reduces the estate tax's top marginal rate (the rate paid on the last dollar taxed) to 47 percent for 2005; it provides for additional declines of 1 percentage point annually through 2007. At that point, the maximum rate under EGTRRA will stabilize at 45 percent from 2007 through 2009. (In 2002, the amount of the gift tax exemption rose permanently to $1 million.) In 2010, EGTRRA is slated to repeal estate and generation-skipping transfer taxes and cut the top rate on taxable gifts to equal the top rate in the individual income tax, currently legislated to be 35 percent. All of EGTRRA's provisions are now scheduled to expire on December 31, 2010. Thus, in 2011, the estate and gift tax will return to its unified pre-EGTRRA form, with a top marginal rate for that year of 55 percent. In addition, the amount of an estate and taxable gifts that is exempt from taxation will drop to $1 million.

EGTRRA's provisions also address state death taxes. In 2005, the law fully repeals the credit for state death taxes and replaces it with a deduction for death taxes paid to any state or the District of Columbia. In 2011, when EGTRRA expires, the deduction for state death taxes is again replaced by a credit.

EGTRRA has substantially reduced the number of estates that are subject to the estate tax compared with the number affected under earlier law. For example, before EGTRRA, about 30,400 estates would have been subject to the tax in 2005; now, analysts expect that about 16,700 will be affected. Similarly, under prior law, about 38,100 estates would have been subject to the tax in 2010, compared with none under EGTRRA.

Estate planning under EGTRRA has become significantly more complicated: people now face not only the traditional uncertainty about when they will die and what the ultimate size of their estate will be but also the complexity of legislated phaseouts and repeals and the ultimate reinstatement of the estate and gift tax. EGTRRA has also complicated the transfer of wealth to heirs during one's lifetime through the strategic use of gifts (called inter vivos gifting), which is a significant part of many taxpayers' estate planning.

Several options could be designed to modify the scheduled phaseouts and eventual repeal of the estate tax (and generation-skipping transfer taxes). They range from freezing EGTRRA's provisions as they stand in particular years (options 1 and 2) to accelerating the repeal of estate taxes (options 3 and 4).

- Option 1 would retain the estate and gift taxes but permanently freeze the exemption and top marginal rate at their levels in 2005—for an estate exemption of $1.5 million, a taxable gift exemption of $1 million, and a top marginal rate of 47 percent. In 2005 as well, the state death tax credit would be fully phased out and treated as a deduction. This option would increase revenues by $40.8 billion over the 2006-2010 period. Receipts would rise in 2007 and several subsequent years but would drop after 2011, when EGTRRA's provisions would have expired. Approximately 18,800 estates would be required to pay some federal estate tax in 2009 under this option, compared with approximately 12,300 under EGTRRA.

- Option 2 would retain the unified estate and gift tax but permanently set the exemption at $3.5 million and the top tax rate at 50 percent, starting in 2005. It would also phase out the state death tax credit fully in 2005 and treat state death tax payments as a deduction. Under the option, approximately 4,600 estates would be required to file federal estate and gift tax returns in 2006, compared with approximately 15,700 under EGTRRA. The option would trim revenues by $21.0 billion over the 2006-2010 period.

- Option 3 would permanently repeal the estate tax in 2005. It would retain the gift tax, with an exemption of $1 million, and set the top gift tax rate to equal the top individual income tax rate. As is the case under EGTRRA, the option would allow each estate to increase, or "step up," the basis of the assets being transferred by as much as $1.3 million. In addition, a spouse would be allowed to step up the basis of inherited assets by another $3 million. Over the period from 2006 through 2010, the option would reduce revenues by $154.1 billion.

  Those elements of the option that relate to asset basis affect the calculation of capital gains (or losses)—and any applicable taxes—when the inherited assets are eventually sold. A capital gain or loss on an asset is measured by the proceeds received from its sale minus the taxpayer's basis in the property. A taxpayer's basis generally represents his or her investment in an asset. "Carryover basis" on inherited property means that the basis of an asset in the hands of the heir is the same as it was in the hands of the decedent. "Stepped-up basis," for estate tax purposes, means that the basis of the property passing from a decedent's estate is generally the fair market value on the date of the decedent's death or on the alternate valuation date, as specified by law.

- Option 4 would make the repeal of EGTRRA's estate tax provisions permanent in 2010 and permanently freeze its gift tax provisions according to the law's specifications for that year. The option would reduce revenues by $8.6 billion over the 2006-2010 period.

A major advantage of all of these options is that by providing more certainty about future estate and gift tax law, they would simplify estate planning. Another potential benefit would be the options' exemption of smaller estates (or in the case of options 3 and 4, all estates) from the filing of estate tax returns, which would reduce the filing burden of those taxpayers. Under the options, smaller estates would also be less likely to incur estate tax liability, which would reduce the likelihood of small businesses having to liquidate to pay estate taxes.

Yet the first two options, which would retain the estate and gift taxes, could hurt small businesses. Under those options, federal estate tax returns would still have to be filed for some estates, and some would still incur estate tax liability.

Opponents of repealing the estate tax support the progressivity of estate and gift taxes and believe that such taxes lessen the concentration of wealth in the United States. A further drawback of repeal is that it could reduce charitable giving because it would eliminate the tax deduction for charitable bequests and thus an incentive that encourages individuals to make bequests. Additional arguments against repeal are, first, that the negative impact of the estate tax on small estates and closely held businesses (for example, family-owned firms) could be largely avoided by increasing the amount of the estate that was exempt from taxation (rather than repealing the tax); and second, that even before EGTRRA, very few businesses were forced to liquidate to pay estate taxes. Another consideration is that the options for repeal do not eliminate the filing burden because many estates will still need to file returns and pay estate tax under state law.

Analysts hold a variety of views on how estate and gift taxes affect savings, the accumulation of capital, and economic growth. Research in those areas is inconclusive.

RELATED CBO PUBLICATION: *The Estate Tax and Charitable Giving*, July 2004

Revenue Option 42

Eliminate the Gift Tax Annual Exclusion for Life Insurance Premiums

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.1	+0.1	+0.1	+0.1	+0.2	+0.6	+1.7

Source: Joint Committee on Taxation.

The tax code includes a gift tax that is levied on transfers of wealth during a taxpayer's lifetime and an estate tax that is imposed on such transfers when a person dies. Credits and exemptions are built into the system; for example, under current law, a donor may exclude from taxation $11,000 annually in gifts to a recipient. (The exclusion increases by $1,000 for every 10 percent rise in the consumer price index.) As a result, most transfers of wealth are not taxed, and typically, an estate tax filing occurs in fewer than 2 percent of deaths.

The proceeds from life insurance policies are frequently part of an estate, and over the years, the tax code has treated them in different ways. By 1942, all proceeds from policies that the decedent owned or paid premiums on were taxable. But legislation enacted in 1954 dropped the "premiums paid" test, which led to the current system in which only policies owned by the decedent are included in the base on which the estate tax is figured.

That approach offers an assured tax benefit to the insured taxpayer during his or her lifetime if the policy provides whole-life rather than term insurance. (Term insurance offers insurance benefits only for a specific period. Whole-life insurance, as its name implies, is not bounded by a specific term, and its proceeds are assumed to be transferred at death.) Payouts on life insurance policies are not counted as transferred wealth when the policy's owner is not the decedent. (The U.S. tax code and regulations of the Internal Revenue Service define the owner of a life insurance policy.) Thus, an important element of estate tax planning during a wealthy taxpayer's lifetime is to make the payments on life insurance policies, with the intended heirs as the beneficiaries, directly or through trust arrangements. Funding provided by a taxpayer that is used to pay premiums on a life insurance policy is not taxed as a gift as long as it totals less than the annual amount that the law allows to be excluded (in 2005, $11,000).

This option would eliminate that exclusion and require that money used to pay premiums on whole-life policies be subject to the provisions of the gift tax. It would increase revenues by about $0.6 billion between 2006 and 2010.

An advantage of this option is that it could help in allocating resources more productively. If the gift tax exclusion could no longer be applied to the payment of life insurance premiums, people would have less of an incentive to create trust arrangements whose sole purpose was to lower their estate tax liability. But the option also has a prominent disadvantage: it could raise the cost of transferring wealth in cases in which assets were not liquid. For example, the option would make it more costly for the owner of a closely held business (typically, a small business or farm with only one or a few owners) to acquire life insurance to "prepay" the estate tax. That aspect of estate planning is designed to keep heirs from having to sell the business to pay the tax.

RELATED OPTION: Revenue Option 43

Revenue Option 43

Eliminate Nonbusiness Valuation Discounts Under the Estate Tax

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+0.5	+0.5	+0.5	+0.5	+0.4	+2.4	+6.0

Source: Joint Committee on Taxation.

Current law imposes a gift tax on transfers of wealth during a taxpayer's lifetime and an estate tax on such transfers at death (see Revenue Option 42 for more details). Some taxpayers cut their estate and gift tax liabilities by transferring marketable securities, such as stocks and bonds, to holding companies, which then issue shares (claims to the securities) to the taxpayers' intended heirs. In many instances, when the estate tax is calculated, those shares are assessed not at their full value but at a discount. That accounting practice is commonly applied to minority holdings (basically, those representing less than a 50 percent interest) in businesses that are not publicly traded.

The practice of discounting derives from the estate tax system's goal of taxing only the value that buyers and sellers might place on a business's assets. It can be justified on the grounds that a buyer who purchased a minority share in an ongoing business operation would generally pay less than the market value for it because the shareholder or shareholders who had a majority share could adversely affect the long-term value of the minority owner's portion. (For example, majority owners of a company who are also its officers can make decisions that increase their income at the expense of minority owners' income.)

Discounting nonbusiness assets, however, is difficult to defend on the same basis. As that approach is applied in nonbusiness situations, a taxpayer typically contributes marketable assets (such as cash, foreign currency, publicly traded securities, real property, annuities, or non-income-producing property including art or collectibles) to a family limited partnership or limited liability company. Simultaneously, the taxpayer gives or bequeaths minority interests in that holding company to his or her intended heirs. The taxpayer then claims discounts on those gifts following the guidelines generally agreed upon for transferring business assets. In short, the taxpayer claims a reduced value for the marketable asset simply because it was placed in a holding company before being given or bequeathed.

Under this option, the practice of valuation discounts would be limited to the assets of active businesses, a change that would boost revenues by $2.4 billion over the 2006-2010 period. For holdings in a nonbusiness entity, their value would be determined as a proportional share of the fair market value of the entity's net worth (provided that its net worth included assets that were readily marketable when given or bequeathed). If the entity was part of an active business, the portion of its net worth that was held in marketable securities and used as working capital would be subject to the usual business valuation practices.

RELATED OPTION: Revenue Option 42

Revenue Option 44

Eliminate the Source Rules Exception for Inventory Sales

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+1.9	+4.9	+5.0	+5.1	+5.2	+22.1	+49.6

Source: Joint Committee on Taxation.

U.S. multinational corporations generally pay U.S. tax on their worldwide income, including the income they earn from operations of their branches or subsidiaries in other nations. Foreign nations also tax the income from those operations, and the U.S. tax code allows multinational firms to take a limited credit for that foreign income tax. The credit is applied against the U.S. taxes that the firms would have owed on that income, but it cannot exceed what the firms would have owed if the income had been earned in the United States. If a corporation pays more foreign tax on its foreign income than it would have paid on otherwise identical domestic income, it accrues what the tax code calls excess foreign tax credits.

In contrast to income generated by operations abroad, the income that corporations earn from products that are sold abroad but produced domestically results almost entirely from value created or added in the United States. Hence, the income that U.S. firms receive from exports typically is not taxed by foreign nations. But the tax code's "title passage" rule specifies that the source of a gain on the sale of a firm's inventory is the place to which the legal title to the inventory "passes." If a firm exports its inventory abroad, the title passage rule allocates the income from those sales in a way that, in effect, sources half of it to the jurisdiction in which the sale takes place and half to the place of manufacture. In practice, that means that if the firm's inventory is manufactured in the United States and sold abroad, half the income from the sale is still treated as though it were foreign in source—even though the firm may have no branch or subsidiary located in the place of sale and the foreign jurisdiction does not tax the income.

The upshot of the title passage rule is that a firm can classify more of its income from exports as foreign in source than could be justified solely on the basis of where the underlying economic activity occurred. A multinational firm with excess foreign tax credits can then use those credits to offset U.S. taxes on that foreign income. As a result, about half of the export income received by companies with such credits is effectively exempted from U.S. tax, and the income allocation rules essentially give U.S. multinational corporations an incentive to produce goods domestically for sale by their overseas subsidiaries.

This option would replace the title passage rule with one that apportioned income for the purpose of taxation on the basis of where a firm's economic activity actually occurred. The change would increase revenues by $1.9 billion in 2006 and $22.1 billion over the 2006-2010 period.

Export incentives, such as those embodied in the title passage rule, do not boost overall levels of domestic investment and employment, nor do they affect the trade balance. They increase profits—and thus investment and employment—in industries that sell substantial amounts of their products abroad. But the U.S. dollar appreciates as a consequence, making foreign goods cheaper and thereby reducing profits, investment, and employment for U.S. firms that compete with imports. Export incentives, therefore, distort the allocation of resources by misaligning the prices of goods relative to their production costs, regardless of where those goods were produced.

Foreign tax credits granted under U.S. tax law were intended to prevent businesses' income from being taxed both domestically and abroad. But the title passage rule allows income from exports that is not usually subject to foreign tax to be exempted from U.S. taxes as well—which means that the income escapes business taxation altogether. Hence, allowing multinational corporations to use foreign tax credits to offset the U.S. taxes they would otherwise owe on export income may be an inappropriate use of such credits.

Among the disadvantages of eliminating the title passage rule are a perceived need, cited by some observers, to provide U.S. corporations with an advantage over foreign corporations that operate in the same markets. But U.S. corporations without excess foreign tax credits receive no advantage. Thus, the rule gives U.S. multinational exporters a competitive advantage over U.S. exporters that conduct all of their business operations domestically (and it gives U.S. multinational exporters that have excess foreign tax credits an advantage over those that do not).

RELATED CBO PUBLICATION: *Causes and Consequences of the Trade Deficit: An Overview*, March 2000

Revenue Option 45

Make Foreign Subnational Taxes Deductible Rather than Creditable

						Total	
(Billions of dollars)	**2006**	**2007**	**2008**	**2009**	**2010**	**2006-2010**	**2006-2015**
Change in Revenues	+3.0	+6.7	+6.9	+7.2	+7.5	+31.3	+73.3

Source: Joint Committee on Taxation.

Under current law, U.S.-owned corporations may deduct state and local income taxes from their taxable income. However, they receive tax credits—a more favorable tax treatment in this instance than deductions—for income taxes that they pay to foreign governments, including foreign subnational governments such as foreign states, cities, and provinces. The credits are applied against the U.S. taxes that the firms would have owed on that income; they cannot exceed what the firms would have owed if the income had been earned in the United States. This option would treat income tax payments to foreign subnational governments the way that payments to domestic state and local governments are treated. That change would increase tax revenues by $3.0 billion in 2006 and $31.3 billion over the 2006-2010 period.

Specifically, this option would continue to allow corporations to receive a limited credit for foreign taxes provided that those taxes exceeded a fixed percentage of either the corporations' foreign-source income or their foreign income taxes. That percentage would be set to reflect the overall ratio of state and local taxes to federal income taxes within the United States. Taxes for which credits were denied would be deducted from a corporation's foreign-source gross income to yield its foreign-source taxable income. The option could be structured to either defer to or override existing tax treaties that call for other kinds of tax treatment.

An advantage of this option would be its potential to level the playing field between domestic and foreign investment by slightly reducing the incentive that U.S.-based multinational corporations now have to invest more abroad than at home. That incentive arises particularly in countries where the overall foreign income tax on a foreign investment is less than the combined U.S. federal, state, and local taxes on a domestic investment. In turn, treating foreign and domestic investment similarly in the tax code would allocate capital more efficiently worldwide.

In some respects, however, removing the creditability of income taxes paid to foreign subnational governments would have drawbacks. The option would make U.S. corporations operating in a foreign country less competitive with other foreign companies operating there and would probably lead some firms to repatriate less income from prior overseas investments to avoid paying the additional U.S. tax. Furthermore, if foreign countries implemented similar rules for taxing income that their corporations earned in the United States, those firms might curtail their U.S. investments, and the amount of capital flowing into the United States might decline.

RELATED CBO PUBLICATION: *Causes and Consequences of the Trade Deficit: An Overview*, March 2000

Revenue Option 46

Increase the Excise Tax on Cigarettes by 50 Cents per Pack

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+6.7	+6.6	+6.7	+6.7	+6.7	+33.4	+66.8

Source: Joint Committee on Taxation.

Taxes on certain goods and services can influence consumers' choices and lead people to purchase less of the taxed items than they might otherwise have bought. That taxation generally results in a less efficient allocation of society's resources—unless some of the costs associated with the taxed items are not reflected in their price. This option would increase the federal excise tax on cigarettes by 50 cents per pack. It would generate $6.7 billion in additional revenues in 2006 and a total of $33.4 billion in revenues from 2006 to 2010. Those estimates include reductions in income and payroll taxes that result from the higher amount of tax-deductible excise taxes.

Tobacco is one such product that creates "external costs" for society that are not covered in its pretax price—for example, higher costs for health insurance (to cover the medical expenses linked to smoking) and the damaging effects of cigarette smoke on the health of nonsmokers. Taxes on tobacco increase prices and can result in consumers' paying more of the external costs of smoking. In addition, higher taxes have also been shown to reduce the consumption of tobacco. Researchers estimate that each 10 percent increase in the price of cigarettes is likely to lead to a decline in consumption of 2.5 percent to 5 percent, with probably a larger drop for teenagers.

Tobacco is taxed by both the federal government and the states. Currently, the federal excise tax on cigarettes is 39 cents per pack; other tobacco products are subject to similar levies. Federal tobacco taxes raised about $7.9 billion in 2003, or about 0.4 percent of total federal revenues. In recent years, state excise taxes have increased from an average of 42 cents per pack in 2000 to an average of about 60 cents per pack in 2004. In addition, settlements reached between states' attorneys general and major tobacco manufacturers require payments of fees equal to an excise tax of about 50 cents per pack. Those taxes and quasi-taxes raise the price of a pack of cigarettes by $1.49.

No consensus exists about the magnitude of the external costs of smoking, which makes it difficult to determine the appropriate level of tobacco taxes. Some analysts estimate that the external costs of smoking are significantly less than the taxes and settlement fees now levied on tobacco. Others maintain that the external costs are greater and that taxes should be boosted even more. Technical issues cloud the debate; for example, the effect of secondhand smoke on people's health is uncertain. Much of the controversy centers on what to include in figuring external costs—such as whether to consider tobacco's effects on the health of smokers' families or the savings in spending on health care and pensions that result from smokers' shorter lives. Nevertheless, an increase in excise taxes on cigarettes may be desirable, regardless of the size of the external costs, if consumers underestimate the harm done by smoking or the addictive power of nicotine. Teenagers in particular may not be capable of evaluating the long-term effects of beginning to smoke.

Arguing against taxes on tobacco is their regressivity. Such taxes take up a greater percentage of the earnings of low-income families than of middle- and upper-income families because lower-income people are more likely than other income groups to smoke and because expenditures on cigarettes by people who smoke do not rise appreciably with income. Moreover, some observers would argue against the option on the grounds that paying higher prices for cigarettes does not make people smoke less.

RELATED CBO PUBLICATION: *The Proposed Tobacco Settlement: Issues from a Federal Perspective*, April 1998 (The proposal discussed in that publication does not reflect the final settlement.)

Revenue Option 47

Increase All Alcoholic Beverage Taxes to $16 per Proof Gallon

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+4.5	+5.5	+5.6	+5.7	+5.7	+27.0	+56.9

Source: Joint Committee on Taxation.

In levying the federal excise tax per ounce of ethyl alcohol, current law treats alcoholic beverages in different ways. Taxes remain much lower on beer and wine than on distilled spirits, and they are figured on different liquid measures. Distilled spirits are measured in proof gallons, a standard measure of a liquid's alcohol content; the current rate of $13.50 per proof gallon translates into a tax of about 21 cents per ounce of alcohol. Beer, however, is measured by the barrel, and the current rate of $18 per barrel reflects a tax of about 10 cents per ounce of alcohol (assuming an alcohol content for beer of 4.5 percent). The current levy on wine is $1.07 per gallon—or about 8 cents per ounce of alcohol (assuming an average alcohol content of 11 percent). In 2003, the federal government collected approximately $8.5 billion in revenues from excise taxes on distilled spirits, beer, and wine.

This option would standardize the base on which the federal excise tax is levied and use the proof gallon as the measure for all alcoholic beverages. It would also increase the tax to $16 per proof gallon, boosting revenues by about $4.5 billion in 2006 and a total of almost $27 billion between 2006 and 2010. (Those estimates include reductions in income and payroll taxes that result from the higher amount of tax-deductible excise taxes.) A tax of $16 per proof gallon comes to about 25 cents per ounce of ethyl alcohol. This option would thus raise the tax on a 750-milliliter bottle of distilled spirits from about $2.14 to $2.54, the tax on a six-pack of beer from about 33 cents to 81 cents, and the tax on a 750-milliliter bottle of table wine from about 21 cents to 70 cents.

The consumption of alcohol creates costs to society that are not reflected in the pretax price of alcoholic beverages. Examples of those "external costs" include expenditures related to health care that are covered by the public, losses in productivity that are borne by others besides the alcohol consumer, and the loss of lives and property in alcohol-related accidents and crimes. Calculating such costs is difficult; however, a study reported by the National Institute on Alcohol Abuse and Alcoholism estimated that the external economic costs of alcohol abuse exceeded $100 billion in 1998—an amount far greater than the revenues from current taxes on alcoholic beverages.

Research has consistently shown that higher prices lead to less consumption and less abuse of alcohol, even among heavy drinkers. Increasing the price of alcoholic beverages by boosting excise taxes would reduce the external costs of alcohol use and make consumers of those beverages pay a larger share of those costs. Moreover, increasing excise taxes to reduce consumption may be desirable, regardless of the effect on external costs, if consumers are unaware of or underestimate the extent of alcohol's addictive qualities and the harm they do themselves by drinking.

Yet taxes on alcoholic beverages have their downside as well. They are regressive; that is, they take up a greater percentage of income for low-income families than for middle- and upper-income families. In addition, taxes on alcohol fall not only on problem drinkers but also on drinkers who impose no costs on society and are thus unduly penalized. A further consideration is that taxes may reduce consumption by some light drinkers whose intake of alcohol might produce beneficial health effects.

Revenue Option 48

Increase Excise Taxes on Motor Fuel by 12 Cents per Gallon

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+16.7	+16.8	+17.0	+17.3	+17.7	+85.5	+181.6

Source: Joint Committee on Taxation.

Federal taxes on motor fuel are credited to the Highway Trust Fund, which is used to finance highway construction and maintenance. Currently, taxes of 18.4 cents and 24.4 cents are levied on each gallon of gasoline and diesel fuel, respectively. This option would raise those taxes by 12 cents per gallon, increasing revenues by about $16.7 billion in 2006 and $85.5 billion over the 2006-2010 period. (Those estimates include reductions in income and payroll taxes that result from the higher amount of tax-deductible excise taxes.) The total federal tax on gasoline under this option would be 30.4 cents per gallon.

The rationale for the option is based on economic efficiency (the allocation of society's resources to their most productive use). Imposing new or higher taxes on petroleum would improve efficiency to the extent that those taxes reflected the external costs imposed by the use of petroleum. (External costs are costs to society that are not covered in a good's or service's pretax price.) For example, making petroleum more expensive would encourage people to drive less and purchase more-fuel-efficient cars and trucks, which could lessen the costs that pollution and congestion impose. Less consumption of motor fuel would also reduce carbon dioxide emissions and could therefore help moderate the effects of human activity on the global climate.

Current tax levels, however, may already be adequate to increase the price of fuel to its full socially appropriate cost. In that case, raising the price further, under some analysts' calculations, might create economic distortions (such as fuel consumption that was inefficiently low in terms of society's well-being). In addition, increasing tax rates on motor fuels raises some issues of fairness. Higher rates that are "passed through" by the trucking industry as higher prices for consumers would impose a disproportionate cost on rural households; yet the costs associated with vehicle emissions and congestion are greatest in densely populated areas, primarily the Northeast and coastal California. Moreover, some researchers argue, taxes on gasoline and other petroleum products are regressive—that is, they take up a greater percentage of the income of lower-income families than of middle- and upper-income households. Other researchers, however, find that the effects of such taxes are proportionate.

RELATED OPTIONS: 270-05 and Revenue Option 29

RELATED CBO PUBLICATIONS: *Fuel Economy Standards Versus a Gasoline Tax,* March 2004; and *Reducing Gasoline Consumption: Three Policy Options*, November 2002

Revenue Option 49

Eliminate the Federal Communications Excise Tax

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	-4.0	-5.6	-5.9	-6.3	-6.6	-28.4	-67.0

Source: Joint Committee on Taxation.

The federal communications excise tax is levied on the charges for selected forms of communication, primarily long distance and local telephone services. Policymakers initially enacted the tax in 1898, when telephone service was a "luxury" good, in order to raise revenues during the Spanish-American War. Over the next century, the tax was repealed and then reinstated; rates ranged from 1 percent to 10 percent. For the past two decades, the rate has remained at 3 percent. Today, telephone service has become nearly universal among U.S. households, and the telephone is no longer considered a luxury. This option would eliminate the federal communications excise tax, reducing revenues by $4 billion in 2006 and $28.4 billion over the 2006-2010 period. Those estimates include increases in income and payroll taxes that result from the lower amount of tax-deductible excise taxes.

The main rationale for eliminating the tax is that it has harmful effects on economic efficiency (the allocation of resources to their most productive use). Innovations in the communications industry have led to a range of untaxed services that are similar to the taxed services that are available. (Such innovations include the "bundling" of services—most commonly, of local telephone and long-distance services together with dial-up Internet access—as well as other forms of communication through the Internet. Typically, bundling results in a fixed monthly fee that includes a monthly charge for a certain number of minutes of a service.) The uneven application of the communications excise tax reduces efficiency by distorting consumers' choices among the various kinds of goods, leading buyers to make decisions that they might not have made in the absence of the tax. Those newer, untaxed products are a close enough substitute for more traditional telephone services that consumers' behavior today may be distorted by the tax to an even greater extent than it was in the past, when those options were not available.

Another argument against retaining the tax is that it is regressive. In paying the tax, lower-income individuals use a larger percentage of their income than higher-income individuals use. Adding to the tax's regressive nature is that the communications industry's new untaxed alternatives are generally more available to affluent members of society. Moreover, difficulties have arisen in administering the tax because the changing technological environment and mechanisms for pricing have led to unresolved legal challenges to portions of the levy.

An argument in favor of retaining the tax is that it is difficult to evade—the telephone companies collect it—and thus it provides a significant and reliable source of federal revenues. Furthermore, some of its disadvantages could be better addressed by approaches other than the tax's elimination. For example, extending the levy to cover similar services that are not now taxed or eliminating exemptions granted to such groups as nonprofit hospitals and educational institutions would be alternative ways to correct the distortions that the tax creates yet at the same time increase revenues and reduce the tax's regressivity.

RELATED CBO PUBLICATIONS: *Does the Residential Broadband Market Need Fixing?* December 2003; and *Economic Issues in Taxing Internet and Mail-Order Sales*, October 2003

Revenue Option 50

Impose a Tax on Sulfur Dioxide Emissions

						Total	
(Billions of dollars)	2006	2007	2008	2009	2010	2006-2010	2006-2015
Change in Revenues	+0.4	+0.5	+0.5	+0.5	+0.4	+2.3	+4.2

Source: Joint Committee on Taxation.

Under the Clean Air Act, the Environmental Protection Agency (EPA) sets national standards for ambient air quality that are designed to protect the public's health and welfare. EPA defines acceptable levels for six "criteria" air pollutants: sulfur dioxide (SO_2), nitrogen oxides (NO_x), ozone, particulate matter, carbon monoxide (CO), and lead. Along with emissions from natural sources, emissions of air pollutants from stationary sources (such as industrial facilities and commercial operations) and mobile sources (automobiles, trains, and airplanes) contribute to the ambient levels of those criteria substances.

Sulfur dioxide belongs to the family of sulfur oxide gases formed during the burning of fuel that contains sulfur (mainly coal and oil) and during the smelting of metal and other industrial processes. Exposure to high concentrations of SO_2 may aggravate respiratory illnesses and cardiovascular disease. In addition, SO_2 and NO_x emissions are considered the main cause of acid rain, which EPA believes degrades surface waters, damages forests and crops, and accelerates corrosion of buildings.

The Clean Air Act Amendments of 1990 adopted a program to control acid rain, which introduced a market-based system of emission allowances to reduce SO_2 emissions. An emission allowance is a limited authorization to emit a ton of SO_2. EPA allots allowances to affected electric utilities on the basis of both the utilities' past fuel use and statutory limits on emissions. Once the allowances are allotted, the law requires that annual SO_2 emissions not exceed the number of allowances held by each utility plant. Firms may trade allowances, bank them for future use, or purchase them through periodic auctions that EPA holds. Firms with relatively low costs for abating pollution have an economic incentive to reduce their emissions and sell their surplus allowances to firms that have relatively high abatement costs.

This option would tax emissions of SO_2 from stationary sources of combustion that are not already covered under the acid rain program. (Such sources include industrial boilers and electric utilities serving generators that produce less than 25 megawatts of power.) The rate of the tax would be based on the average cost of an additional reduction in SO_2 emissions by those sources. That approach would result in a tax of $200 per ton of SO_2, which would both encourage further reductions in pollution and increase revenues by about $2.3 billion over the 2006-2010 period. (The estimate includes reductions in income and payroll taxes that result from the higher amount of tax-deductible excise taxes.) Major sources of pollutants, under the 1990 amendments to the Clean Air Act, currently pay user fees to cover the costs of a program that provides operating permits (stating which air pollutants a source is allowed to emit). Basing the tax described in this option on the terms granted in the permits would minimize the Internal Revenue Service's costs of administration.

In general, taxes on emissions can help lessen pollution in a cost-effective (least-cost) manner. The tax described in this option would lead to reductions in SO_2 emissions by encouraging firms with abatement costs that are less than the tax to cut their emissions and, at the same time, allowing firms with abatement costs that exceed the tax to continue emitting pollutants and pay the levy.

Opponents of this kind of tax, however, argue that it would impose a large burden on affected firms. Businesses covered under this option would not only pay a tax on their emissions of SO_2 but in most cases would also incur some costs for abatement (such as the cost of scrubbers and other equipment to reduce emitted pollutants). By contrast, regulatory approaches that mandated reductions in emissions would not require firms to pay that kind of levy on their allowed emissions.

RELATED OPTION: Revenue Option 51

RELATED CBO PUBLICATIONS: *An Evaluation of Cap-and-Trade Programs for Reducing U.S. Carbon Emissions*, June 2001; and *Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program,* June 1998

Revenue Option 51

Impose a Tax on Nitrogen Oxide Emissions

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+3.0	+4.3	+4.1	+4.0	+3.9	+19.3	+37.6

Source: Joint Committee on Taxation.

Nitrogen oxides (NO_x) usually enter the air as the result of high-temperature combustion processes such as those found in automobiles and power plants. Emissions of NO_x play an important role in the atmospheric reactions that generate ground-level ozone (smog) and acid rain. Moreover, the Environmental Protection Agency (EPA) believes that NO_x can irritate the lungs and lower a person's resistance to respiratory infections such as influenza. Nitrogen oxides and pollutants formed from them can be transported over long distances, so problems associated with NO_x are not confined to the areas where they are emitted.

The Clean Air Act requires states to implement programs to reduce ground-level ozone. Because of the transportability of NO_x and ozone, the law requires upwind states to establish programs that will help downwind states meet statutory standards. In 1998, EPA promulgated the Ozone Transport Rule (commonly referred to as the NO_x Sip call), which required 22 eastern states and the District of Columbia to revise their programs so as to reduce NO_x emissions beyond the levels previously mandated under the Clean Air Act. (The rule was subsequently revised to cover all or part of 21 states.) The rule did not mandate specific methods but instead gave each affected state a target for NO_x emissions.

In addition, EPA established the Federal NO_x Budget Trading Program, a cap-and-trade arrangement for emissions allowances. Under the program, sources of emissions are issued a specific number of allowances that entitle them to emit a limited amount of NO_x each year. Firms are required to hold an allowance for each ton of NO_x that they emit and are free to buy and sell allowances. Large electricity-generating units and industrial boilers may participate in the program provided that the state in which they are located approves.

Another way to help control NO_x would be to tax emissions from stationary sources in states not covered by the NO_x Sip call. Such a tax would apply to industrial facilities and commercial operations, including electricity-generating units and industrial boilers as well as other sources; it could provide significant revenues and encourage further reductions in pollution below the level that current regulations require. Controlling NO_x from stationary sources costs between $500 and $10,000 per ton of emissions abated. Imposing a tax of $1,500 per ton of emissions would encourage stationary sources that could reduce NO_x at a cost below that amount to do so. Facilities with abatement costs that were higher than the tax could continue to pollute and pay the levy. A tax of $1,500 per ton would boost revenues by $3.0 billion in 2006 and $19.3 billion over the 2006-2010 period. Those estimates include reductions in income and payroll taxes that result from the higher amount of tax-deductible excise taxes.

Proponents of taxing pollution argue that such levies discourage activities that impose costs on society and could help reduce air pollution in a cost-effective (least-cost) manner. However, opponents of that kind of tax contend that it would impose a large burden on affected firms. Companies that this option would cover would not only pay a tax on their emissions of NO_x but in most cases would also incur costs for abatement (such as the cost of scrubbers and other equipment to reduce emitted pollutants). By contrast, regulatory approaches that simply mandated reductions in emissions would not require firms to pay such a tax.

RELATED OPTION: Revenue Option 50

RELATED CBO PUBLICATION: *Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program,* June 1998

Revenue Option 52

Reinstate the Superfund Taxes

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+1.1	+1.7	+1.7	+1.7	+1.8	+8.0	+17.7

Source: Joint Committee on Taxation.

Since 1981, the Superfund program of the Environmental Protection Agency (EPA) has been charged with cleaning up the nation's most hazardous waste sites. Most Superfund cleanups are paid for by the parties that are held liable for contamination at individual sites. In many cases, however, the liable parties cannot be identified, no longer exist, or are unwilling or unable to undertake the job. In such cases, EPA pays for the cleanup and, where possible, tries to recover the costs through subsequent enforcement actions.

Money to pay for those EPA-led cleanups and other costs of the Superfund program comes from an annual appropriation. Traditionally, the Congress has designated two sources of funds in the appropriation: the general fund and balances in the Superfund trust fund (formally, the Hazardous Substance Superfund). Revenues credited to the trust fund have come primarily from taxes on petroleum and various industrial chemicals and from a corporate environmental income tax. However, authorization for the taxes expired in December 1995, and beginning in 1997, the fund's balance steadily declined. By the end of 2003, it was essentially zero.

As the fund's balance dropped, reliance increased on the general fund as a source of the program's appropriated money. Through 1999, the annual contribution from the general fund never exceeded $250 million; from 2000 to 2003, it was roughly $600 million to $700 million. Starting in 2004, EPA's appropriation allows the program to be financed entirely from the general fund, drawing from the trust fund only "such sums as are available." The trust fund will remain a minor source of money unless it receives a new or renewed stream of revenues. One option would be to reinstate the excise taxes on petroleum and chemicals and the corporate environmental income tax. Doing so would yield revenues of $1.1 billion in 2006 and $8.0 billion over the 2006-2010 period. (Those estimates include reductions in income and payroll taxes that result from the higher amount of tax-deductible excise taxes.)

Proponents of reauthorizing the taxes argue that they are consistent with the "polluter-pays" principle. Specifically, proponents maintain that petroleum products and various chemical feedstocks and derivatives are common sources of contamination at Superfund sites and thus it is fair that producers and users of such substances, as well as corporations more broadly, foot much of the bill for the site cleanup program. Some advocates of renewed taxation also argue that EPA needs a stable source of funding for Superfund, for two reasons: to maintain multiyear cleanup efforts at the largest sites and to continue to provide a credible threat that the agency will clean up sites and recover the costs of that work from liable parties who do not undertake cleanups themselves.

Some people who oppose reinstating the taxes argue that the Superfund program should not be given dedicated funding until the Congress reforms the program's liability system and clarifies its future mission. Other opponents criticize the taxes themselves. First, they argue, taxing all firms in an industry or all corporations above a certain size, regardless of their individual past or present waste-disposal practices, does not embody the polluter-pays principle and has none of the desirable properties related to efficiency and equity that are commonly associated with it. Such taxes provide no incentive to firms to handle waste carefully or, better yet, avoid creating it in the first place. Moreover, the burden of paying such taxes tends to fall on the firms' (current) customers, through higher prices, rather than on (past) stockholders or managers. Second, opponents of reinstating the taxes point to research showing that the costs to administer and comply with such levies are high, compared with the relatively small amounts of revenues that were collected. Tax opponents also note that Superfund spending has always been subject to annual appropriations and that dedicated taxes are therefore no guarantee of stable funding.

Revenue Option 53

Impose an "Upstream" Tax on Carbon Emissions

(Billions of dollars)	2006	2007	2008	2009	2010	Total 2006-2010	Total 2006-2015
Change in Revenues	+11	+18	+19	+20	+21	+89	+208

Source: Joint Committee on Taxation.

Scientists have identified carbon dioxide, which is emitted during the combustion of fossil fuels (oil, natural gas, and coal) as a key greenhouse gas that can affect the Earth's climate, but people disagree about whether anything should be done to reduce those emissions. One general area of consensus is that if steps are taken to reduce them, the approaches used should achieve the reductions at the lowest possible cost. Imposing a tax on carbon emissions would be one method of accomplishing that and would be relatively simple to administer. (Establishing a trading program for rights to emit carbon would be another such method.) Such a tax would reduce emissions and increase revenues by about $89 billion over the 2006-2010 period. The estimate includes reductions in income and payroll taxes that result from the higher amount of tax-deductible excise taxes.

A tax on carbon emissions would entail the fewest economic distortions if it was administered "upstream," where carbon enters the economy (that is, when fossil fuels are imported or produced domestically), rather than "downstream," where carbon actually enters the atmosphere (when fossil fuels are burned). Under an upstream levy, producers and importers of fossil fuels would be taxed on the basis of the carbon emissions that were released when their fuel was burned. The tax would lead to higher prices for those fuels and for goods and services that required a great deal of carbon-intensive energy (for example, from coal) to produce. Those higher prices in turn would give the United States' entire economy an incentive to reduce carbon emissions.

Ideally, the rate of the tax (measured in dollars per ton) would reflect the damages avoided by emitting one less ton of carbon today. The benefits of reducing carbon emissions, however, are uncertain. Assessing those benefits involves determining the relationship between carbon emissions and the change—and rate of change—in temperature in different parts of the globe, as well as concomitant changes in other aspects of the climate, such as rainfall, severity of storms, and sea levels. It also requires evaluating the impact of changes in regional climates on natural and human systems—such as property loss and effects on species and human health—and calculating the pecuniary value of those effects (both those that may be damaging and those that may be beneficial).

The process of estimating and imputing measurable values to impacts on the climate is further complicated by the fact that benefits and costs will arise at widely different points in time. The benefits from avoiding climate change would probably come in the distant future—some researchers estimate that most of the benefits will occur after 2100. Yet the cost of policies enacted to avoid damages would be incurred beginning today. Traditionally, analysts apply a discount rate to the value of benefits that occur in the future, thus placing more weight on current costs than on future benefits. But how to discount the future benefits that society would reap from avoiding climate change is a controversial question. Some analysts argue that the discounting method should reflect the "opportunity cost" of funds that are dedicated to climate change—that is, the return that dollars invested in alternative investments might yield. Other analysts maintain that such a method would place too little value on the benefits received by future generations. They argue that considerations of equity necessitate choosing a lower discount rate than that implied by the observed opportunity cost of funds.

Given the difficulties in determining the benefits of reducing carbon emissions, any estimate of an "optimal" tax should be viewed as only a rough approximation. Nevertheless, most proponents of imposing a tax agree that starting off with a modest levy and increasing it over time would be the best approach because it would give the economy time to adjust to using less fossil fuel and allow for flexibility in policymaking. One of the most comprehensive attempts to determine the size of a tax on carbon emissions that would strike a balance between current costs and future benefits was undertaken by researchers at Yale. They suggested a worldwide tax that would begin at roughly $12 per ton in 2005 and rise to $17 per ton in 2015.[1] The tax would be levied on carbon emissions worldwide, whereas the tax in this option would apply only to emissions produced by facilities in the United States. Although a worldwide tax would induce low-cost reductions of emissions around the globe, a domestic tax would be borne primarily by U.S. citizens. At the same time, the benefits of any reduction in emissions would be distributed worldwide, with benefits likely to be greatest in developing countries.

The desirability of a carbon tax remains controversial. Some opponents of such a tax contend that it would impose a large burden on the economy and produce uncertain benefits. Other opponents argue for a different approach to reducing carbon emissions. They maintain that establishing a fixed limit, or cap, on emissions would be better than instituting a tax because a limit would provide more certainty about how much carbon emissions were actually reduced.

1. Specifically, William D. Nordhaus and Joseph Boyer, in *Warming the World* (Cambridge, Mass.: MIT Press, 2000, p. 133), suggested that an optimal world tax on carbon, measured in 1990 U.S. dollars, would begin in 2005 at $9.15 and increase to $12.73 by 2015. An inflation index based on a GDP (gross domestic product) deflator was used to convert those amounts to the current-dollar figures that appear above.

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